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ECONOMIC REPORT

WINTER 1981-82

INTERNATIONAL EDITION

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WINTER 1981-82

Number 65

This report highlights the outlook for the international economy through 1982.

Subsequent issues of the ECONOMIC REPORT will discuss the following topics:

Long-Term U.S. Outlook, Spring 1982
1983 California Outlook, Summer 1982
1983 U.S. Outlook, Fall 1982

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SUMMARY

The economic policies promoted by the Reagan Administration in the United States in 1981 have had a definite impact both at home and abroad. Since most countries have had to take account of the economic forces generated in the United States, an examination of the likely developments in the U.S. economy during 1982 appears to be highly germane.

Domestically, the administration's fiscal and monetary policies restrained real GNP growth and lowered the inflation rate. These policies combined with inflation expectations kept interest rates relatively high for much of 1981 in comparison with recent historical averages. Simultaneously, the trade-weighted value of the U.S. dollar strengthened substantially, reaching average quarterly levels not seen since 1971.

The stronger U.S. dollar, which appreciated an estimated 17.9 percent on a trade-weighted basis in 1981, in comparison with 1980's average value, cut two ways in 1981. First, it reduced the effective price for U.S. imports, which helped to restrain domestic inflationary pressures. Second, the stronger dollar tended to increase the level of merchandise imports above what it would have been, while making U.S. exports less competitive internationally. In 1982, however, the outlook is for the dollar to depreciate 3.6 percent, on average, relative to its estimated average value in 1981.

As a partial result of the less-competitive position of U.S. exports and less-expensive imports, the merchandise-trade deficit for 1981 is projected at $27.8 billion, an increase from 1980's $25.3 billion deficit. At the same time, the current account is expected to run a $2.6 billion surplus, a decline from the $3.7 billion surplus in 1980. In 1982, however, both the merchandise-trade and the current-account balances are expected to deteriorate seriously, with the current account switching to a large $11.2 billion deficit.

Internationally, the administration's economic policies have also grabbed the attention of policymakers in most other countries. Slower U.S. economic growth and high interest rates have had a pronounced effect on both developing and industrialized countries. First, the current U.S. recession has cut the demand for the exports of most countries, including those in OPEC, impeding the ability of many countries to pay for their imports. In addition, the capacity of many less-advanced countries to finance development projects diminished. Second, high interest rates generally spread worldwide in 1981, necessarily affecting the domestic economic performances of other countries. Furthermore, interest-rate levels have raised the cost of external borrowing, which has been particularly burdensome to the less-developed countries (LDCs).

Prospects for the industrialized countries in 1982 feature some acceleration in real growth, continued progress in reducing inflation, and a slight improvement in the aggregate current-account deficit. Economic policies in the major industrial economies are expected to be marginally less restrictive in 1982 than in 1981. Average unemployment rates are expected to rise further in 1982, although the rate of increase should slow in the second half. Even though the industrial countries' recovery from the second "oil shock" has been agonizingly slow, the policies being followed in 1981-82 are producing some lasting benefits: serious energy conservation measures are showing impressive results; lower long-term inflation rates are being steadfastly pursued; and private-sector free enterprise is being stimulated.

Due, in part, to generally low rates of real economic growth in the industrialized economies, the volume of world trade is expected to show little change in 1981 in comparison to 1980 levels. In 1982, real trade should increase approximately 1 percent. The value of world trade, on the other hand, is projected to decline about 8 percent in 1981, the first decline since 1958. In 1982, the value of world trade is forecast to increase 9 percent over year-earlier levels.

Despite the poorer growth performance of the developing world, the resilience of these economies to the kind of disruptions seen during 1979-81 is growing. This resilience, which is largely based on the greater geographic and product diversity of their export sectors, will be examined in some detail.

Crude oil prices — important to both OPEC and the rest of the world — increased dramatically in 1979 and 1980. For 1981, the average price of OPEC crude oil is estimated at $34.50 per barrel, an 11.8 percent increase from 1980's average price. In 1982, the average nominal price of crude oil is forecast to remain near the 1981 level, implying a decrease in the real price. The outlook for the 1981 and 1982 aggregate OPEC current account is for a continuing but declining surplus, $63.6 billion and $54.0 billion, respectively, after peaking at $100.7 billion in 1980. The decline in the surplus results from the average crude oil price being held constant in 1982 in comparison to the 1981 level and a continuing rise in imports of goods and services.

OUTLOOK FOR THE U.S. ECONOMY, THE DOLLAR, AND THE CURRENT ACCOUNT

Real economic growth in the United States in 1981 is estimated to have risen to nearly 2 percent from 1980's −0.2 percent rate, but it is forecast to decline to only 0.6 percent in 1982. A strong expansion, however, is expected during the second half of the year. Simultaneously, the inflation rate is projected to fall somewhat during 1982 in comparison to the rate in 1981. Due to several factors, including interest-rate trends, the general economic situation in the United States and other industrialized economies, and political considerations, the average trade-weighted value of the U.S. dollar should have appreciated by almost 18 percent in 1981 relative to its average 1980 value. In 1982, the average value of the dollar is forecast to depreciate about 3.6 percent from its value in 1981. Due, in part, to the stronger dollar in 1981, the U.S. current-account surplus should have decreased to $2.63 billion from 1980's $3.72 billion surplus. In 1982, however, the current-account is projected to switch to an $11.2 billion deficit, the first in four years.

Successive sections of this article contain, first, a forecast of the U.S. economy for the remainder of 1981 and through 1982; second, the outlook for the U.S. dollar; and finally, an examination of the estimated U.S. current-account surplus for 1981 and the deficit anticipated for 1982.

THE U.S. ECONOMY

The Outlook for 1982

The U.S. economy is currently being buffeted by the negative forces of prolonged tight money compounded by a moderate inventory cycle. A relatively high level of interest rates in the United States has been damaging credit-sensitive industries such as housing and motor vehicles for some time; but that damage, however injurious to those sectors, was grudgingly accepted as a byproduct of the anti-inflationary monetary policy as long as the rest of the economy performed well and unemployment remained within acceptable limits. In late 1981, the damage of prolonged high interest rates and tight money became increasingly more generalized and an involuntary inventory buildup occurred in response to sluggish consumer spending and widespread order cancellations. Up to that time, inventory building had been very gradual due to the carrying costs associated with high interest rates.

The apparent re-emergence of the inventory cycle means that the economy probably has entered a new phase in which weakness is becoming more widespread. Observers have been reluctant to label the worsening economic conditions in 1981 a recession up to now because the declines were slight and largely limited to a few, generally very credit-sensitive, sectors of the economy such as housing and producers' durable equipment spending. In addition to the continuing weakness in those sectors of the economy, and with badly sagging sales prospects for motor vehicles, the downturn now appears to be affecting previously immune sectors such as consumer expenditures for nondurable goods and services.

The current economic downturn probably will extend into the early months of 1982, when cyclical forces will help turn the economy around. The reduction of inventory levels will be a major depressant of the late-1981 and early-1982 economy. When that process is completed, probably sometime during the second quarter of 1982, inventory rebuilding should resume as a result of an expected pickup in consumer spending beginning in the first quarter. The bottom of the inventory cycle should also be accompanied by a further easing in interest rates, which would augment the rise in retail sales and business spending. By mid-1982, the economy should be well on the path to a cyclical recovery that will receive a further boost from the additional 10 percent cut in personal income taxes effective on July 1. The third quarter of 1982 should see real growth attaining a transitory peak near 6 percent before settling into a more typical expansion path late in the year and into 1983.

Although consumer spending is now being restrained by various forces including high interest rates, rising unemployment, and an apparent increase in the saving rate, the fundamental determinants of consumer spending appear generally favorable for 1982. Following an expected slow start early in the year and a gradual expansion toward midyear, the consumption sector can be expected to expand rapidly due to the strong real income gains during the second half. The effect of the 10 percent tax cut during July combined with the expansive effect of cost-of-living adjustments to federal transfer payments during that month, could produce real growth in personal disposable income exceeding a 10 percent annual rate during the third quarter. Even with an expected sizable increase in the saving rate, the potential for growth in consumption out of income alone is considerable.

Additionally, the consumer sector currently is characterized by high levels of pent-up demand for housing, automobiles, and other durable goods, and should respond favorably to the cut in income taxes and the general improvement in after-tax real income. Finally, the liquidity position of the consumer sector also supports an outlook for an increase in consumer spending once the economic climate improves. Unless financial conditions should worsen considerably during 1982, the prospects for gains in consumer spending appear favorable, particularly during the second half.

Prospects for capital spending appear mixed for 1982. Inventories, which are anticipated initially to be a drag on the early-1982 economy, should switch to an expansionary force before midyear. Business spending for producers' durable equipment should follow a cyclical path, lagging initially due to a generally weak pattern of product demand during early 1982, then accelerating in the second half in response to stronger retail sales, improved profitability, and a general improvement in financing conditions. The recent tax provisions for accelerated depreciation also will give a boost to equipment purchases, although the timing will mainly reflect cyclical factors.

A sector that appears headed for some trouble next year is the nonresidential structures component of capital spending. Nationwide surveys of industrial and particularly commercial building markets have recently been showing moderate increases in vacancy rates, indicating that the shortages of the past few years have generally been alleviated, with a sizable backlog of projects still under construction. These considerations support an outlook for a fairly sharp decline in nonresidential construction in 1982, until vacancy rates return to lower levels.

Government spending for goods and services is likely to be a declining sector of the economy in 1982, as modest gains in real federal spending should be outweighed by a decline of almost 2 percent in state and local spending. Federal government purchases of goods and services will be held in check by spending cuts recently voted in the nondefense sector, although a surge in defense spending will contribute to some overall growth. Spending by state and local governments will be affected adversely both by cuts in federal grants-in-aid, an important source of state-local funds, and by recessionary weakness in revenues that will serve to restrain spending due to prohibitions on deficit finance in most jurisdictions.

Real GNP growth in the United States is expected to average only 0.6 percent in 1982, compared with the 1.9 percent gain estimated for 1981. The 1981 pattern, however, began with a quarter of very strong growth (an 8.6 percent annual rate of increase), and was followed by one quarter of downturn (–1.6 percent), one quarter of very slow growth (0.6 percent) and a final quarter of downturn (an estimated –5.0 percent). The year 1982, in contrast, is expected to begin with a quarter of decreasing output and to end with a very strong second-half growth trend. From the fourth quarter of 1981 to the fourth quarter of 1982, real GNP growth should be 3 percent, considerably above the average, year-over-year increase. The inflation trend in the United States should show fundamental improvement in 1982. As measured by the Consumer Price Index for all urban consumers, prices are expected to increase 8.4 percent, compared with the estimated 10.5 percent rise in 1981, and 13.4 percent in 1980. The moderating trend in energy costs that began in 1981 should be accompanied by a lower rate of increase in homeownership costs and less-than-double digit gains in retail food prices.

Monetary Policy

Judgments about monetary policy tightness or ease are often made by examining the wrong indicator — interest rates. The problem with using interest rates as a guide is that they must be considered on an after-inflation basis to obtain any meaningful information, but most people ignore that detail. A better way of judging monetary policy is to examine the behavior of the monetary aggregates over a sustained period of time.

An analysis of monetary aggregate behavior over the last few years indicates that Federal Reserve authorities allowed excessive growth during 1977-79. In addition, the Federal Reserve missed its clearly enunciated targets in both 1979 and 1980. Early in 1981, M-1B (currency plus checkable deposits) rose very modestly. In April, however, transactions money began to grow rapidly causing the Federal Reserve to tighten up on its credit reins. Because of the succeeding quick response, it now seems a virtual certainty that the Federal Reserve undershot its 1981 target for this crucial aggregate. Despite this likelihood, the Federal Reserve has been reluctant to pursue a sharply easier policy because the more broadly defined aggregates, M-2 and M-3, have been at the top of or above their target ranges all year.

The divergent growth of the various aggregates relative to their targets raises the question of whether or not the targets were mutually consistent from the beginning. In order to set consistent targets, policymakers must understand the intricate inter-relationship among the aggregates over time and over the economic cycle, as well as forecast the economy correctly. In 1981, however, vast changes occurred in the financial system, including nationwide NOW accounts, further deregulation of interest rates, shifts in reserve requirements, continued major inroads by money-market funds, and important, new tax-law revisions. Add to these changes an unstable and uncertain economy and the case becomes stronger that the historical relationships on which the targets were based have evolved sufficiently to render the 1981 targets mutually inconsistent.

For 1982, the Federal Reserve has elected to notch downward by half a percentage point its target range for the narrowly defined money supply (which will again be called M-1 since NOW accounts are expected to be fully phased in and M-1A will no longer be relevant). The ranges for the more broadly defined aggregates and for bank credit will be left unchanged from their respective 1981 targets.

Outlook for Federal Reserve Policy and Interest Rates

Even at the risk of substantially slower economic recovery, the Federal Reserve must meet its targets in 1982 if it wishes to retain credibility with financial market participants. Based on our economic forecast, it appears likely that the monetary objectives outlined for 1982 will be attained. Their attainment, however, will require persistence by the Federal Reserve and higher interest rates than would normally be expected during a period of economic recovery. Overall, however, short-term interest rates are expected to average significantly below their 1981 level while long-term rates experience only modest improvement.

Given our forecast that nominal GNP will rise 11 to 12 percent between the fourth quarter of 1981 and the fourth quarter of 1982, the new M-1 target implies a 6 percent increase in income velocity. Though this figure appears high by historical standards, it is below the velocity growth experienced in 1981 (if M-1B is adjusted for shifts from savings accounts).

Furthermore, large increases in income velocity tend to occur in the early stages of economic recovery, and the financial innovation still underway may have set a new, higher growth path for velocity. If, instead, velocity reverts to a lower path, it will be particularly difficult for the monetary authorities to meet their targets without sharply higher interest rates than those underlying this forecast.

THE U.S. DOLLAR

The 1981 Performance

The value of the dollar, on a trade-weighted basis, is estimated to have risen an unexpectedly large 17.9 percent in 1981, in comparison with its average value in 1980. As of the third quarter of 1981, the value of the dollar had increased 28.8 percent over its value one year earlier.

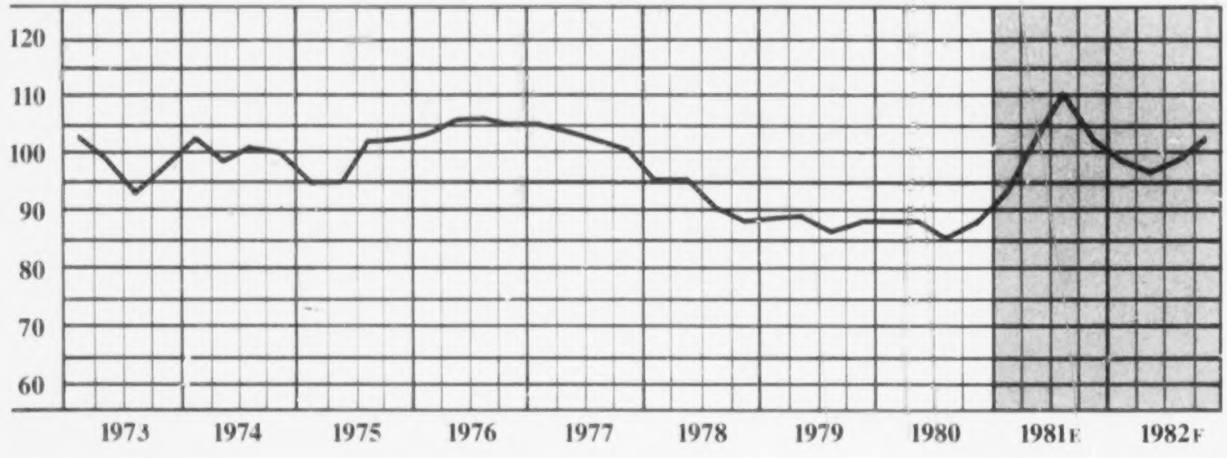
The appreciation of the dollar during 1981 resulted primarily from generally high interest-rate levels, the U.S. economy's relatively good performance as reflected in trade and inflation numbers, and optimism about the Reagan economic package. Additionally, the dollar's strength was periodically reinforced as external political disturbances flared up, affecting the outlook for other currencies. The appreciation of the dollar was particularly strong against the Japanese yen, in spite of the fact that the Japanese economy dramatically improved its current-account position and inflation rate. Interestingly, the weakness of the yen in 1981 contrasted to its strength in 1980, when Japan's economic performance was, in fact, poorer. Later in 1981, however, the yen's weakness moderated, as did the slides experienced earlier in the year by other major currencies. Concurrently, many of these other currencies began to move more in concert with each other.

Beginning in the fourth quarter of 1981, the dollar is expected to lose value through the first half of 1982. A 2.2 percent decline in the dollar is estimated for the fourth quarter, in comparison to its third-quarter level. The reversal in the trend for the dollar is primarily attributable to turnarounds in the trends for the factors mentioned above, i.e., generally declining interest rates, a weaker current-account performance, less-favorable inflation numbers, and growing scepticism about the Reagan economic package, particularly with regard to its fiscal implications.

The 1982 Outlook

The media have presented much discussion in recent months of a collapse, or at least a significant acceleration of the depreciation of the dollar in 1982. Such conjecture is based, to a major degree, on the impact of the 1981 appreciation of the dollar on the nation's trade competitiveness in 1982. Additional factors in the forecast leading to a depreciation of the dollar include arguments that interest rates will continue to decline rapidly throughout most of 1982, at the same time as the Reagan economic policies come increasingly under attack and the fiscal deficit mounts.

TRADE-WEIGHTED QUARTERLY AVERAGE EXCHANGE RATE FOR U.S. DOLLAR



Index: March 1973 = 100

E = Estimate F = Forecast

This forecast is not based upon such a pessimistic point of view. It does, however, include a 6.8 percent decline in the trade-weighted value of the dollar through the first half of 1982, in comparison to its estimated value for the fourth quarter of 1981, and a 3.6 percent decline for the year relative to its average 1981 value. The depreciation of the dollar should occur as the current account shifts to a large deficit after the surpluses of 1980 and 1981. This swing will place downward pressure on the dollar, but, for two major reasons, insufficient pressure to lead to a collapse of the dollar.

First, the impact of the 1981 appreciation of the dollar on U.S. trade competitiveness will lessen during the course of the year. A lag factor is typically associated with the impact of exchange-rate variations on changes in trade. This factor implies that the expected decline in the value of the dollar will have a positive effect on U.S. exports in the second half of 1982, partially offsetting the negative effects of the postponed increase in real growth in other industrial countries in 1982. Second, the lower average real growth rate projected for the U.S. economy during 1982 in comparison to 1981's rate will slow the growth of U.S. imports.

Although the current account will deteriorate seriously in 1982, it is not considered to be the crucial element determining the value of the dollar. In this forecast, interest-rate differentials are felt to outweigh current-account developments. The anticipated continued decline in U.S. interest rates during the first and second quarters will be the primary contributor to the dollar's weakness during that period. It should be noted, however, that as the year progresses, the pro-dollar effect of more stimulative economic policies and lower interest rates in other countries will increasingly offset the anti-dollar effect of the decline in U.S. interest rates. The slowing of the rate of decline in interest rates through mid-1982, followed by the projected slight rise in the third quarter and the stronger increase in the fourth quarter will provide a significant upward impetus for the dollar during late 1982.

The psychological impact of the Reagan economic package is more difficult to determine. Market sentiment continues to evidence latent concern about the prospects for success with respect to the fiscal program. Nevertheless, a strong willingness to endorse any positive outcome of the program is also discernable. In effect, foreign-exchange markets seem very much to want the Reagan program to be a success, but they also seem to be keeping an "I won't believe it until I see it" attitude.

Despite the way in which the markets may react to the administration's economic program, 1982 will prove a pivotal year for the program. If the program succeeds, then the dollar should gain long-run strength. It should be noted, however, that the dollar could appreciate simply from a mere turn in the direction of many key economic trends. Such favorable turns could include, among others, increasing rates of productivity leading to a reduction in the core rate of inflation, along with some semblance of fiscal responsibility, implying less reliance on monetary policy. Hence, the Reagan economic package could lead to a stronger dollar without achieving its goals completely.

Indeed, even if the program is partially unsuccessful in the sense that the fiscal deficit continues to grow, the dollar would not necessarily weaken. For example, a large fiscal deficit may increase inflationary expectations, resulting in higher interest rates, which could lead to at least a temporary appreciation of the dollar.

In the preceding section on the dollar in 1981, it was noted that international political events generally favored a stronger dollar during the year. Although such events are difficult to forecast even in general terms, they merit explicit notice. The situation in Poland is likely alternatively to simmer and boil for some time, before a real solution is found; but as it evolves, relations among the United States, the Soviet Union, and Western Europe should remain in a state of flux. The greater military and economic exposure of the Western European nations negatively influences the outlooks for their currencies, which necessarily has positive implications for the dollar. Additionally, the leftward political tilts in France and Greece along with greater uncertainty in West Germany make it more difficult for the European nations to orchestrate successfully their economies toward commonly held objectives. Admittedly, the unstable political situation makes events on the European continent less easy to interpret. Nevertheless, each of these factors favors a stronger dollar.

The last political component of our dollar forecast is the turmoil in the Middle East, which includes numerous flash-points. Most developments that can be reasonably anticipated — short of the United States being drawn into a major conflict — imply a stronger dollar. In this regard, one of President Reagan's major successes is the de-control of U.S. oil prices, which has led to the continued slow growth in the demand for, and the potentially increased output of, energy. These results have already begun to whittle away at the U.S. dependence on Middle Eastern oil, while the dependence of almost all other major industrial countries remains huge.

To summarize the forecast, the trade-weighted value of the dollar will continue to decline through the first half of 1982 because of lower U.S. interest rates and the eroding domestic economic performance. The further one moves into 1982, however, the greater will be the stabilizing impact on the dollar of interest rates leveling off and then beginning to rise in the second half of the year. The fundamental performance of the economy will also be stronger as the year progresses. Although the core rate of inflation will remain high in 1982, our forecast incorporates a modest improvement in the rate at which prices will increase. This projection is based partially on the fact that the Reagan package begins to address this long-term problem. This improvement is seen as positive, or at least, a neutral factor influencing the dollar's strength. The political factors discussed above could significantly alter this outlook. In general, though, these factors are anticipated to produce upward pressure on the value of the dollar over the forecast period.

THE CURRENT ACCOUNT

In 1981, the U.S. current-account surplus should have amounted to approximately $2.63 billion, a decline from 1980's $3.72 billion surplus. The smaller surplus is due to a larger merchandise-trade deficit, a larger net-services surplus, and a larger deficit on the net transfers account. In 1982, however, a substantial deterioration in the merchandise-trade and net-services accounts should cause the current account to switch to a deficit of about $11.19 billion, the largest since 1978's $14.07 billion deficit.

Among the conflicting factors playing a significant role in U.S. current-account developments in 1981 were the U.S. recession, low real economic growth rates overseas, relatively high interest-rate levels, and the comparatively strong U.S. dollar. Because of these factors, the merchandise-trade deficit is estimated to have increased to $27.78 billion, on a balance-of-payments basis, from 1980's $25.34 billion, the result of merchandise imports growing more rapidly in value than merchandise exports. (On a Census basis, when imports are valued c.i.f. rather than f.o.b., the estimated merchandise-trade deficit is $39.4 billion.)

Empirical studies indicate that approximately 88 percent of the change in real or price-adjusted merchandise imports can be attributed to the change in U.S. real economic growth and changes in the trade-weighted value of the U.S. dollar. The general decline in economic output for the last nine months of 1981 should have retarded the growth in the volume of merchandise imports, whereas the 17.9 percent rise in the value of the dollar during 1981 should have increased the growth in real imports since it made imports relatively less expensive. Combining the two factors should have resulted in merchandise imports increasing only about 0.9 percent, in real terms, in 1981, using the Department of Commerce's index for imports. Assuming that import prices rise about 2.5 percent on average in 1981, in comparison to 1980 levels, the value of merchandise imports is expected to increase only 5.5 percent over 1980 levels. (Annual percentage increases in value may not necessarily be inferred from the increases for quantity and price because of the quarterly pattern.)

Through the first three quarters of 1981, the value of merchandise imports (on a balance-of-payments basis) increased 6.3 percent over the same period one year earlier; but the net effect of an increase in the value of fourth-quarter-1980 imports and the decline estimated for the fourth quarter of 1981 should have lowered the year-over-year gain.

At the same time, statistical investigations show that approximately 94 percent of the change in quantity of merchandise exports can be explained by changes in real economic growth overseas (where the aggregate real growth rate for the six largest OECD economies minus the United States is used as a proxy) and changes in the value of the dollar. Because of lower economic growth in these economies and the stronger dollar, the quantity of merchandise exports is expected to decline 3.8 percent in 1981, relative to levels in 1980. Assuming that U.S. export prices rise about 8.8 percent in 1981, on average, the value of merchandise exports is expected to increase only an estimated 5 percent over 1980 levels. For the first nine months of 1981, the value of merchandise exports (on a balance-of-payments basis) rose 7.7 percent from levels for the comparable period in 1981. Again, the net effect of growth in export value in the fourth quarter of 1980 and the decline expected for the fourth quarter of 1981 should have reduced the percentage increase for all of 1981 over 1980's total.

The net-services account, which has been a major source of strength in recent years, is expected to register a $37.61 billion surplus in 1981, a modest increase from 1980's $36.12 billion surplus. Service exports are expected to grow an estimated 8.9 percent to $131.5 billion, whereas service imports are projected to rise 11.1 percent over 1980 levels to $93.9 billion. The effect of high interest-rate levels on the net-services account should be partially offset by the effect of poorer business conditions during the second half of 1981, and the resulting fall in profit levels. The estimated current-account surplus of $2.63 billion results when the merchandise-trade deficit and the net-services surplus are added to the assumed net-transfer outflow of $7.2 billion.

In 1982, the merchandise-trade deficit is forecast to swell to $40.01 billion, on a balance-of-payments basis (and $56.8 billion on a Census basis). Although the volume of merchandise exports is forecast to fall about 4.1 percent in 1982 as a whole, significant growth should occur during the second half of the year. The average trade-weighted value of the dollar forecast for 1982, even though lower than that estimated for 1981, is still 13.6 percent higher than the average value for 1980. Hence, U.S. exports will not get a great boost from the depreciation of the dollar occurring during the last quarter of 1981 and through the first half of 1982. Furthermore, the outlook calls for real growth overseas to be very low during the first half of 1982, and only begin to strengthen significantly during the second half of the year. As the demand for U.S. exports grows, however, the dollar is forecast to appreciate, thus offsetting part of the growth in exports caused by the more vigorous growth abroad. Therefore, 1982 is unlikely to be a good year for U.S. exports. With export prices forecast to rise in the neighborhood of 6.8 percent, the value of exports is projected to rise only slightly more than 4 percent.

U.S. MERCHANDISE-TRADE AND CURRENT-ACCOUNT DATA, 1980-1982

(Millions of U.S. Dollars)

	1980	1981E	1982F
Merchandise Trade			
Exports	223,966	235,245	244,845
Imports	–249,308	–263,020	–284,855
Balance	–25,342	–27,775	–40,010
Services			
Exports	120,701	131,500	133,465
Imports	–84,580	–93,895	–97,190
Balance	36,121	37,605	36,275
Transfers, net			
Official	–4,659	–4,650	–4,750
Other	–2,397	–2,550	–2,700
Balance	–7,056	–7,200	–7,450
Current-Account Balance	3,732	2,630	–11,185

E = Estimate F = Forecast

On the other hand, the quantity of merchandise imports is expected to increase about 3.3 percent in 1982, with most of the growth taking place in the second half of the year. The second-half increase is due to the sharp rise in real economic growth in the latter half of 1982. The modest depreciation of the dollar through the first two quarters of the year will not cause imports to increase sharply, and the appreciation taking place over the second half of the year will mitigate part of the effect of increased domestic real growth. Assuming that import prices rise about 4.2 percent for the year, the value of imports should increase approximately 8.3 percent during the year in comparison with 1981 levels.

The surplus on the services account is expected to decline in 1982 to $36.28 billion. Service exports are forecast to increase only about 1.5 percent to $133.47 billion while service imports rise by 3.5 percent to $97.19 billion. Among the factors influencing service payments during the year, interest rates and general business conditions appear to be the most important. U.S. interest-rate levels are seen as being higher than those overseas, resulting in a greater increase in interest-payment outflows than inflows. Furthermore, profit levels should remain low until well into the second half of the year in all industrialized economies. The rebound of the U.S. economy in the second half of 1982, however, is likely to be significantly stronger than any comparable development in the other industrialized countries over the same period, which should lead to a greater rise in profit outflows than inflows. Finally, the generally strong U.S. dollar, even though weaker than in 1981, should encourage U.S. tourists while discouraging tourists from abroad.

Assuming total transfer-payment outflows amount to about $7.45 billion, a current-account deficit of $11.19 billion is seen for 1982. The current-account deficit forecast for 1982 would be the first since 1978.

OUTLOOK FOR THE INDUSTRIAL COUNTRIES

STRONG DOLLAR LIMITS GROWTH IN 1981

Economic developments in the industrial area as a whole in 1981 were in line with Security Pacific's forecast one year ago. Real GNP/GDP growth continued at about the same unimpressive pace as in 1980, accompanied by the predicted slowing in the weighted-average rate of inflation (consumer prices). Based on expectations of a sharp reduction in the pace of OPEC oil price increases in 1981, SPNB forecast last year at this time that the current-account deficit of the industrial-country area would improve by $20-25 billion. Based on revised figures for 1980 and estimates for 1981, it now appears that the twenty-one industrial countries listed in the forecast table managed to reduce their aggregate current-account deficit by about $24 billion, to $42 billion. Adding the deficits of the three Mediterranean OECD countries (Greece, Portugal, and Turkey), which are covered in another section of this *Report*, the current-account deficit of the OECD countries combined is estimated at $49 billion in 1981.

The sizable current-account improvement stemmed in part from a combination of substantial gains in energy conservation in the industrial countries and a *decline* in crude oil spot prices during much of 1981. Whereas in October 1980, we forecast a 22 percent increase in the average price of OPEC oil in 1981 (versus 65 percent in 1980), SPNB estimates that the actual increase in oil prices will be nearer half that figure. Declining non-oil commodity prices in recent months also contributed to the improved external performance of the industrial country group. Apart from these pervasive factors, the industrial group's current-account balance benefited from large positive swings in the external positions of a few countries, notably the shift from deficit to surplus in Japan, the Netherlands, and Switzerland.

Of the individual major countries covered by this forecast, the United States differed most radically in its economic performance from expectations a year ago. A decline in real GNP of 0.5 percent was forecast, with a pattern of recession in the first two quarters of the year.

followed by a modest recovery in the second half. As it turned out, the U.S. economy expanded very sharply in the first quarter of 1981, then sank back into recession for the remainder of the year. Although the economy was thus statistically weak for most of the year, the exceptionally strong first quarter pushed estimated average GNP growth for the year to nearly 2 percent.

Among the other large industrial economies, Canada also expanded somewhat more than anticipated, as did Japan. Germany and Italy both appear to have posted small declines in the volume of output in 1981 — versus our expectations of virtually unchanged real GNP in those countries — while the French economy stagnated instead of expanding slightly. Finally, the United Kingdom's recession proved somewhat deeper than anticipated.

By late spring/early summer, industrial production in the United States, Japan, and Canada had surpassed year-earlier levels, whereas the principal European economies continued to languish in recession. Available data for Germany, France, the United Kingdom, and Italy suggest that industrial production in all four countries at the end of the third quarter of 1981 was still below the same period in 1980. Moreover, EEC opinion surveys taken in early autumn indicated that while the trough of the European recession was probably past, consumer sentiment was still weak and there was thus little reason to expect anything other than an insipid recovery in 1982.

Most of the smaller industrial nations performed more poorly than anticipated in 1981. Real growth was minimal, with four countries (Belgium, Luxembourg, the Netherlands, and Sweden) experiencing declines in real GDP, and the weighted-average inflation rate for this group actually *rose* fractionally, from 10.5 percent in 1980 to 10.6 percent in 1981. Several countries posted record current-account deficit/GDP ratios in 1981, and the aggregate current-account deficit for the group was reduced by only about 4 billion, roughly one half the anticipated improvement.

Developments in the foreign exchange and financial markets of the industrial countries were the principal factors behind these deviations from 1980's forecasts. The persistence of high interest rates (in both nominal and real terms) in the U.S. and Eurodollar markets, a favorable U.S. economic performance in the first half, and political uncertainties in Europe (France, Poland) and the Middle East, all contributed to a steady strengthening of the U.S. dollar against all of the principal currencies over the first seven months of 1981. As the table on changes in the value of the dollar shows, the dollar appreciated by nearly 24 percent on a trade-weighted average basis between the end of 1980 and July 31, 1981. Against the European currencies, the U.S. dollar recorded even more impressive gains.

CHANGES IN THE VALUE OF THE DOLLAR IN 1981

(Local Currency Units per U.S. Dollar*)

	Deutschemark	Pound Sterling	Yen	Swiss Franc	French Franc	Canadian Dollar	Trade-Weighted Average
1981 Dollar Peak:**							
Month	July	Sept.	July	July	July	July	July
Rate	2.464	1.800	239.45	2.130	5.852	1.235	111.72
Percentage change in U.S. dollar's value from year-end 1980	+25.8	+32.4	+18.0	+19.0	+29.6	+3.4	+23.9
Mid November 1981							
Rate	2.237	1.922	225.35	1.764	5.638	1.188	105.16
Percentage change in U.S. dollar's value since 1981 dollar peak	−9.2	−6.4	−5.9	−17.2	−3.7	−3.8	−5.9

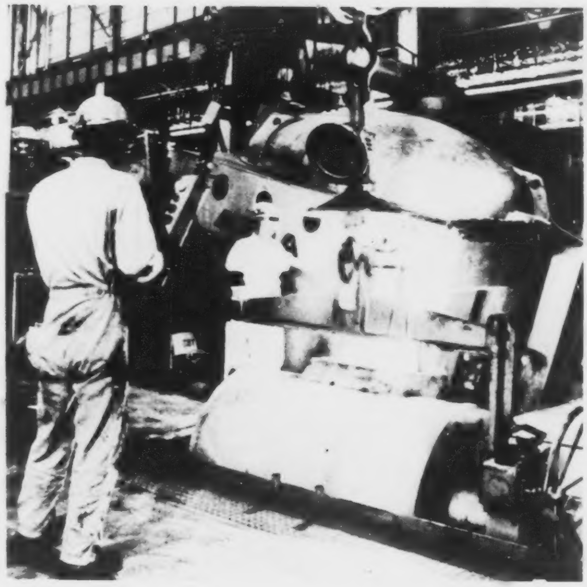
Sources: Individual currencies through September 1981: I.M.F., *International Financial Statistics*. Mid November 1981: SPNB Foreign Exchange Division. Trade-weighted dollar: Board of Governors, U.S. Federal Reserve System.

*Except: sterling, $U.S. per pound; trade-weighted dollar, index value (March 1973 = 100).

**End-of-month basis; actual peak spot market values for the dollar were higher in all cases.

The dollar's strength forced policymakers in the other major industrial countries, particularly in Europe, to maintain tighter fiscal and monetary policies and higher interest rates than would have appeared appropriate in view of their domestic output and employment situations. Unemployment rates in most of the major industrial countries stabilized or tended to fall in the first half of 1981, then began to rise in the third quarter. In France, Belgium, and the Netherlands — three of the EEC countries which are most closely linked by international trade — unemployment rates rose virtually without interruption throughout the year, as in the United Kingdom. On a yearly-average basis, unemployment rates will be higher in the major industrial countries in 1981 than they were in 1980.

Restrictive policies abroad were motivated by the desire to dampen the inflationary impulse generated by currency depreciation and to sustain capital inflows needed to finance still-large current-account deficits. As a result, export growth was inhibited for the smaller industrial countries, most of which depend heavily on the EEC market. High interest rates and tight credit policies generally throughout the developed world also adversely affected business investment, as well as demand for consumer durables and housing.



BETTER PROSPECTS IN 1982

Economic developments in 1981 set in motion corrective processes that should result in some pickup in economic growth in the OECD area over the next 12-18 months. First, world oil prices have softened in response to declining oil consumption in the industrial countries. Excess-supply conditions still exist worldwide and, barring any major oil supply disruptions, OPEC official prices are currently forecast to remain unchanged in 1982, compared to 1981.

The stabilization of crude oil prices, together with reduced oil consumption, means that the OPEC current-account surplus and its depressive effect on real income and purchasing power in the industrial countries will continue to diminish in the year ahead. World market prices of commodities other than oil have also weakened, as has the dollar in recent months, strengthening prospects for a further reduction in inflation rates in the developed countries in 1982. Consumer prices in the industrial countries listed in our forecast table rose on average by nearly 12 percent in 1980; for 1981, the increase is estimated to have been about 10 percent, with a further reduction to the 8.5-9.0 percent area in 1982.

Second, the downturn in the U.S. economy has already resulted in a drop in dollar interest rates, a development which is being reflected with varying lags in other industrial countries. The downward trend in global interest rates is now expected to continue at least until the spring of 1982, facilitated by a gradual ebbing of the dollar's strength against most of the major currencies over the next six months.

Third, exchange-rate movements and improvements in industrial labor costs have considerably strengthened the competitive positions of most industrial countries relative to the United States, and of many of the European countries vis-a-vis the United Kingdom and Japan as well. Thus, stronger export demand is expected to play a key role in the pickup in GDP growth abroad in 1982, particularly for the European nations.

For the industrial countries combined, 1982 is likely to bring little improvement in the overall current-account position, although there should be further current-account gains for the smaller countries and for four of the seven major industrial nations (Japan, Germany, Italy, and Canada). These gains will be at the expense

KEY INDICATORS FOR SELECTED INDUSTRIAL COUNTRIES

	Real Growth (Percent)[1]			Consumer Prices (Percentage Change)[1]			Current-Account Balances (Billions of U.S. Dollars)		
	1980	**1981E**	**1982F**	**1980**	**1981E**	**1982F**	**1980**	**1981E**	**1982F**
Major Industrial Countries	**1.0**	**1.2**	**1.7**	**12.2**	**10.0**	**8.6**	**–34.7**	**–14.7**	**–16.2**
United States	–0.2	1.9	0.6	13.4	10.5	8.6	+3.7	+2.6	–11.2
Japan	4.2	3.9	4.2	8.0	4.9	3.5	–10.7	+8.7	+12.0
Germany	1.9	–0.7	1.6	5.5	5.9	4.8	–15.9	–13.6	–1.5
France	1.4	0.0	2.7	13.3	13.4	14.1	–7.8	–7.0	–7.0
United Kingdom	–2.8	–2.9	1.0	18.0	11.8	10.8	+7.4	+8.6	+1.2
Italy	4.0	–0.8	1.6	21.2	19.5	16.9	–9.8	–7.8	–3.4
Canada	0.1	2.7	2.2	10.1	12.5	11.5	–1.6	–6.2	–6.3
Other Industrial Countries	**1.8**	**0.6**	**1.9**	**10.5**	**10.6**	**9.4**	**–31.9**	**–27.5**	**–22.4**
Australia	1.8	2.8	3.0	10.2	9.7	10.8	–4.3	–8.5	–7.5
Austria	3.6	0.0	2.3	6.3	6.7	5.6	–3.6	–2.5	–2.0
Belgium	1.4	–0.4	0.5	6.7	7.8	7.0	–5.9[2]	–6.8[2]	–6.5[2]
Denmark	–1.0	0.0	2.3	12.3	11.4	10.0	–2.5	–2.0	–2.2
Finland	4.9	2.4	2.5	11.6	12.2	10.1	–1.4	–0.6	+0.2
Iceland	2.5	0.0	1.6	57.3	51.5	48.0	–0.1	–0.1	0.0
Ireland	1.0	1.5	1.0	18.2	19.9	17.8	–1.3	–2.2	–2.1
Luxembourg	0.5	–1.8	0.5	6.2	8.2	7.2	—[2]	—[2]	—[2]
Netherlands	0.8	–1.2	1.4	6.5	6.6	5.6	–2.8	+1.8	+3.5
New Zealand	1.0	2.5	2.9	17.2	15.4	17.0	–0.7	–0.6	–0.8
Norway	3.7	1.0	1.5	10.7	13.7	10.8	+1.0	+1.9	+0.8
Spain	1.7	1.3	2.7	15.6	14.5	13.0	–4.6	–6.4	–5.8
Sweden	1.4	–0.8	1.4	13.7	12.5	10.3	–5.2	–3.2	–2.5
Switzerland	3.2	1.2	1.4	4.1	6.5	5.0	–0.5	+1.7	+2.4
Total, Industrial Countries	**1.2**	**1.1**	**1.7**	**11.9**	**10.1**	**8.8**	**–66.6**	**–42.2**	**–38.6**
Memorandum Items:									
Total Excluding U.S.	1.9	0.6	2.4	11.1	9.9	8.9	–70.3	–44.8	–27.4
EEC Countries (10)[3]	1.0	–0.9	1.7	12.5	11.2	10.4	–40.8	–31.3	–20.7
Other OECD Countries									
Greece	1.6	0.5	2.5	24.9	22.1	25.0	–2.2	–2.3	–2.8
Portugal	4.7	2.5	2.6	16.6	19.0	17.5	–0.9	–1.8	–1.6
Turkey	–0.7	2.0	4.0	110.2	37.0	25.0	–2.7	–2.8	–2.5
All OECD Countries	1.2	1.1	1.8	12.7	10.4	9.0	–72.4	–49.1	–45.5

[1] Aggregate figures for country groups are weighted averages. Weights for both real growth and consumer prices are 1980 GNP/GDP at current prices and exchange rates. The Organization for Economic Co-operation and Development (OECD) uses the same method to compute weighted-average real growth rates, but substitutes *private consumption* for GNP/GDP in its weighted inflation rate calculations.

[2] Luxembourg's current-account balance is included in the figures for Belgium (Belgium-Luxembourg Economic Union).

[3] Greece joined the EEC in January 1981. For purposes of comparison, Greece's figures are included in the EEC totals for 1980 as well.

E = Estimate F = Forecast

of the OPEC countries, the United States, and the United Kingdom.* Lagged adjustments of trade volumes to 1981 exchange-rate movements, combined with further improvements in terms of trade abroad over the next several months, will be important factors behind the improvements in external positions shown in the forecast.

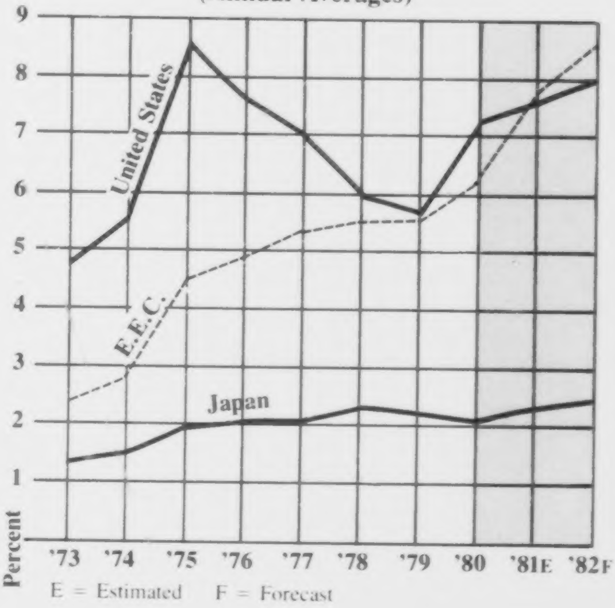
Current-account forecasts are typically subject to a much larger degree of error than those of most macroeconomic variables. Not only do they incorporate assumptions about relative GNP/GDP growth and inflation rates, price trends for important commodities, and the availability of financing, they often involve forecasts of exchange rates. SPNB's methodology is to forecast current-account positions first in local currency terms, then to convert the figures to U.S. dollars using our forecast of the *annual average* dollar exchange rate for each currency.** Thus, the combined effect of relatively minor deviations from the various assumptions can prove to be large in dollar terms. To illustrate, recent published forecasts of current-account positions for several major countries in 1982 range from (billions of U.S. dollars, rounded): United States, −2 to −20; Japan, +5 to +20; Germany, 0 to −18; France, −1 to −8.5; and the United Kingdom, +1 to +9.

Real GNP/GDP is not expected to decline in 1982 in any of the industrial countries, and growth should accelerate on an annual average basis vis-a-vis 1981's rate in all countries except the United States, Canada, and Ireland. The slowdown in U.S. real growth on a year-over-year basis, like the acceleration in 1981, is in large part a statistical phenomenon which results from the uneven quarterly growth. In fact, U.S. real GNP growth is forecast to strengthen after the first quarter of 1982. Canada's average growth rate will be lower in 1982 than in 1981 for similar reasons.

UNEMPLOYMENT RATES IN INDUSTRIAL COUNTRIES

1973-1982

(Annual Averages)



For all of the listed industrial countries combined (on a weighted-average basis), real growth is expected to post only a modest improvement over the 1981 figure, to around 1.7 percent (1.8 percent for all OECD countries), although an accelerating pattern should be evident in most countries over the course of the year. Growth prospects among the industrial nations other than the United States are considerably more favorable than the total, but they are hardly bullish. The most notable feature is the turnaround from a recession to the 1.7 percent average growth rate forecast for the Common Market countries.

Economic policies in the industrialized-country group on balance are expected to be marginally less restrictive than in 1981. France is clearly the leader in this respect among the big countries, but balance-of-payments and exchange-rate pressures will probably force French policymakers to scale back their real-growth objectives as the year progresses. Indeed, some evidence of policy back-tracking has already appeared in France.

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*Excluding the United States, for example, SPNB forecasts an improvement of nearly $17½ billion in the combined current-account position of the industrial countries shown.

**Dollar-denominated balance-of-payments figures which appear in the media and in some other forecasts may use the *current* exchange rate or a forecast of the *year-end* exchange rate for purposes of conversion to U.S. dollars. Still others (the OECD, for example) assume *unchanged* exchange rates for the forecast period. Such differences in method of conversion make comparisons of various forecasts difficult.

Among the other major industrial countries, it would not be surprising to see somewhat higher money-supply target growth ranges established for 1982, reflecting a desire to see the recent downward trend in short-term interest rates continue — as long as lower rates do not conflict with other policy objectives (e.g., inflation and exchange rates). Despite efforts to pare them, government budget deficits in most of the big industrial countries are unlikely to respond very favorably in 1982, if only because further increases in average unemployment rates will act to limit the growth of government tax revenues and to increase government expenditures on transfer payments.

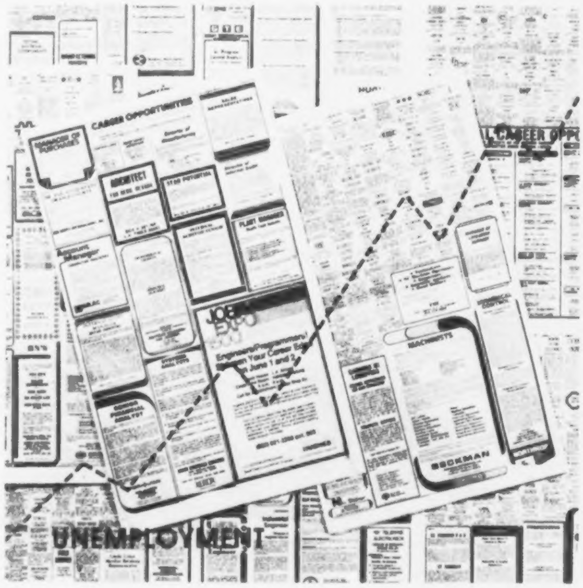
Projected growth rates in real GDP and employment will again be insufficient in 1982 to absorb increases in the labor forces of industrial countries. Average unemployment rates are thus likely to rise further in nearly all industrial countries next year, although the rate of increase in unemployment should slow somewhat in the second half. The problem is particularly serious in Europe, where — given the well-documented lag between GDP growth and improvements in the labor market situation — even the projected turnaround in the EEC economy will not ameliorate the unemployment picture next year. The EEC Commission recently forecast the Community's average unemployment rate in 1982 at 8.5 percent, up from 7.8 percent in 1981. Moreover, judging from early projections, European unemployment will probably increase further in 1983.

To summarize, while prospects for the industrial countries next year are not entirely favorable, 1982 should be a better year than 1981 in most respects — provided our assumptions about exchange rates, interest rates, and oil-market developments are fulfilled. Export growth should strengthen in most countries, while household real incomes should be bolstered by lower inflation and interest rates, leading to somewhat faster growth in the volume of consumer spending, particularly for durables. The decline in interest rates should also facilitate inventory rebuilding and slow the downturn in housing construction in the industrial nations.

A PRE-"POST MORTEM" ON THE NON-RECOVERY

The industrial countries still have not recovered fully from the second "oil shock", in the sense that real GNP/GDP growth is still far below potential and reductions in unemployment have proved ephemeral. In view of the dismal prospects for unemployment and the snail's pace of recovery, it is tempting to ask whether an alternative growth path would have been preferable for either the developed Western economies or the 100-plus countries which account for the other two-fifths of the world's economic pie. Would a sharper recovery in 1981-82 have left the world economy today with fewer problems and less worrisome unemployment prospects?

The short answer is "no": it was tried before (1975-76) and it did not work. In 1979 — i.e., at the beginning of the most recent slowdown — the average unemployment rate in the seven largest industrial countries was already one third higher than it was in 1975, and several of the smaller industrial countries were experiencing unemployment rates that were multiples of the 1975 figures. Short-term interest rates in 1979 (using the six-month Eurodollar rate as a proxy for global rates) averaged 425 basis points higher than in 1975, and the weighted-average inflation rate (consumer prices) in the industrial countries was still nearly double digit. By most accepted measures, the external debt position of the non-oil exporting developing countries worsened between 1975 and 1979, while it has actually improved since then (as discussed in a subsequent article in this *Report*). In the late 1970s, the communist countries' growth prospects for the coming half-decade were rapidly being revised downward, and a major debt-servicing problem began to surface in Poland. Indeed, the only group of countries which really profited ultimately from the stronger recovery after the first "oil-shock" were the oil-exporting countries, which were able to enhance their economic position with another major price boost.



Despite its consequences for unemployment, the slower acceleration in industrial-country growth this time around has produced several lasting benefits for the world economy. First, serious energy-conservation measures have been implemented and are showing impressive results. As one indication, OECD area net imports of crude oil, natural gas liquids, and refinery feedstocks in the first half of 1981 were more than 22 percent lower than they were in the first half of 1979, a percentage reduction that is many times greater than that which would have been predicted from the area's sluggish growth alone.

Second, a widespread recognition has occurred in the non-communist world that unemployment cannot be permanently reduced until the inflation problem is solved. The policy commitment to a lower long-term rate of inflation has manifested itself in sustained, constructive approaches to monetary and credit restraint, as well as in the growing interest in and experimentation with so-called "supply-side" economics. Examples of policy programs fitting this mold include "Thatcherism" and "Reaganomics," the EEC's recently-published proposal for structural/institutional reforms among its member nations over the medium term,*** and the more realistic long-range planning now evident in both the developing and communist countries. The theory behind all such programs is that by stimulating output of — rather than demand for — goods and services, and by altering the productive apparatus in such a way as to improve efficiency, real growth and employment prospects can be enhanced while inflation continues to abate.

Finally, as a concomitant of the "supply-side" approach, private-sector free enterprise is being encouraged while long-term commitments to a reduction in the quantity of resources commanded and consumed by the public sector appear to be proliferating. Interestingly, this trend is visible not only in the non-communist world, but also among the centrally-planned economies. Over the last couple of years, several communist countries have explicitly recognized that rapid state budget growth (especially in the form of subsidies on imports and prices of necessities) is inflationary, and that the so-called non-socialized sector of the economy is capable of producing a wider range of goods and services more efficiently and without abnormal risk of fostering "capitalistic tendencies" than was ever thought possible.

***The "Fifth Medium-Term Economic Policy Programme", published by the Commission of the European Communities in July 1981, discusses at length the European unemployment problem and the need for structural change to combat it.

OUTLOOK FOR WORLD TRADE

The slowdown in real economic growth for the industrialized economies of the world in 1980 and 1981, in comparison to the three previous years, visibly affected the growth of the world's real or price-adjusted trade. In 1982, real economic growth is expected to increase somewhat, relative to 1981 levels; and as a result, the volume of world trade will grow slightly faster for the year. The growth in trade, in price-adjusted terms, however, will not be robust. At the same time, lower rates of inflation and weak commodity prices will cause nominal trade to decline in value in 1981 and rise only 9 percent in 1982.

REAL TRADE GROWTH

As the chart illustrating the percentage change in both the world's (omitting the Eastern bloc countries) real and nominal trade shows, the growth in price-adjusted trade has generally been declining since 1976. Although many factors affect the growth in the volume of world trade, the single best explanatory variable is the change in real economic growth. If the real economic growth rate for the world were known — an extremely difficult figure to calculate — the growth in the world's volume of trade could probably be predicted fairly accurately. The growth rate for the OECD, however, which accounts for more than three fourths of the non-communist world's economic output and in excess of 50 percent of its trade, can be used as a proxy for a world real growth rate. Statistical investigations indicate that nearly 90 percent of the percentage change in the volume of world trade can be explained by the change in real economic growth for the OECD.

In 1979, real economic growth for the OECD was 3.3 percent and the volume of world trade, as measured by imports, rose 5.9 percent. Then, in 1980, when the increase in economic activity for the OECD declined to 1.1 percent, the volume of world imports actually fell a marginal 0.1 percent, the first decrease since 1975. In 1975, world imports fell 4.7 percent when economic output for the OECD economies declined 0.3 percent from 1974 levels — the first annual fall in OECD real economic output in more than twenty years. The lower level of economic activity in 1975 resulted from economies reacting to the first round of oil price hikes (1973-74) when oil prices more than tripled.

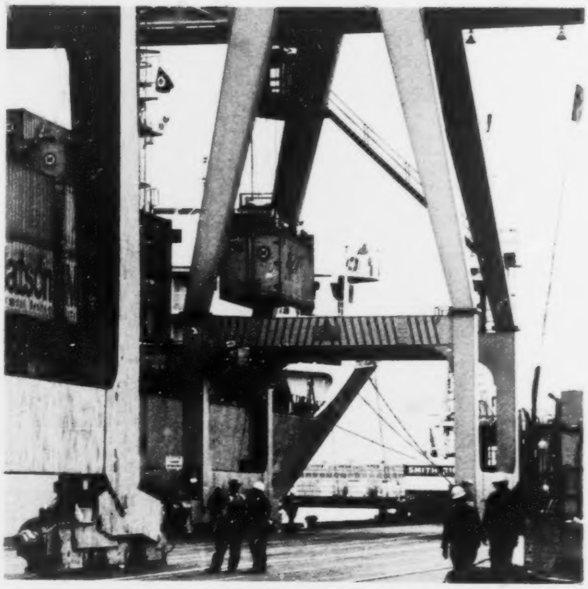
In 1981, real economic growth for the OECD economies is estimated to have been approximately 1.1 percent. As a result, the volume of world trade is expected to have increased between −0.5 and +0.5 percent, a marginal increase, if any, over 1980's rate of growth (−0.1 percent).

The outlook for 1982 is for world trade to rise by approximately 0.5 to 1.5 percent as real growth for the OECD is forecast to increase to about 1.6 percent. The pace of economic activity in the world should quicken as more economies complete their adjustment to the second round of oil price hikes (1979-80) and as they begin to shake off the effects of restrictive monetary policies pursued by the United States and the United Kingdom. Consequently, the volume of world trade is estimated to increase 0.3 percent annually, on a compound-rate-of-change basis, over the first three years of the 1980s, in comparison with 7.8 percent annually for the first three years of the 1970s and 6.3 percent annually for the entire decade of the 1970s.

NOMINAL TRADE GROWTH

Changes in nominal trade, as opposed to real trade, depend not only on changes in the level of economic activity, but on changes in the level of prices for merchandise traded internationally. Hence, price trends for both basic commodities and imports with a higher degree of processing are relevant.

The distinctly lower level of real economic growth in the industrial economies during the 1980-81 period has resulted in a decrease in demand for basic commodities, while simultaneously, supplies of most of these goods have not experienced sharp declines in growth. Commodity supplies are generally fairly unresponsive to price changes over the short run. The estimate for 1981 is that commodity prices fell about 14.5 to 15.5 percent from 1980 levels. After increasing only 0.4 percent in the fourth quarter of 1980 from third-quarter levels, commodity prices as measured by the IMF's price index for "all" commodities decreased 6.8 percent in the first quarter of 1981, 7.8 percent in the second quarter and 4.7 percent in the third quarter. As of the third quarter, commodity prices had declined 17.7 percent from their third-quarter-1980 level. Prices for all four groups of commodities had declined in the third quarter of 1981 over year-earlier levels: food, −23.3 percent; beverages, −20.4 percent; agricultural raw materials, −10.6 percent; and metals, −13.7 percent (metals prices actually increased 0.7 percent in the third quarter over second-quarter levels).



Price trends for manufactured imports depend on domestic rates of inflation in the exporting countries. Many economies experienced distinctly lower rates of domestic inflation in 1981, in the absence of large price hikes for petroleum products (an estimated 11.8 percent increase in 1981 as opposed to 65.3 percent in 1980) and as lower rates of real growth have reduced inflationary pressures. As a result, prices for manufactured exports have not risen as rapidly in 1981. Thus, prices for imports, in general, are expected to have fallen about 8 percent in 1981 in comparison to 1980's 23 percent rise. Hence, nominal trade should have declined about 8 percent, when the 8 percent decrease in import prices is combined with the zero change in the volume of trade expected for 1981. The value of world imports is estimated at $1,765 billion, a $155 billion decrease over 1980's value — the first decline since 1958.

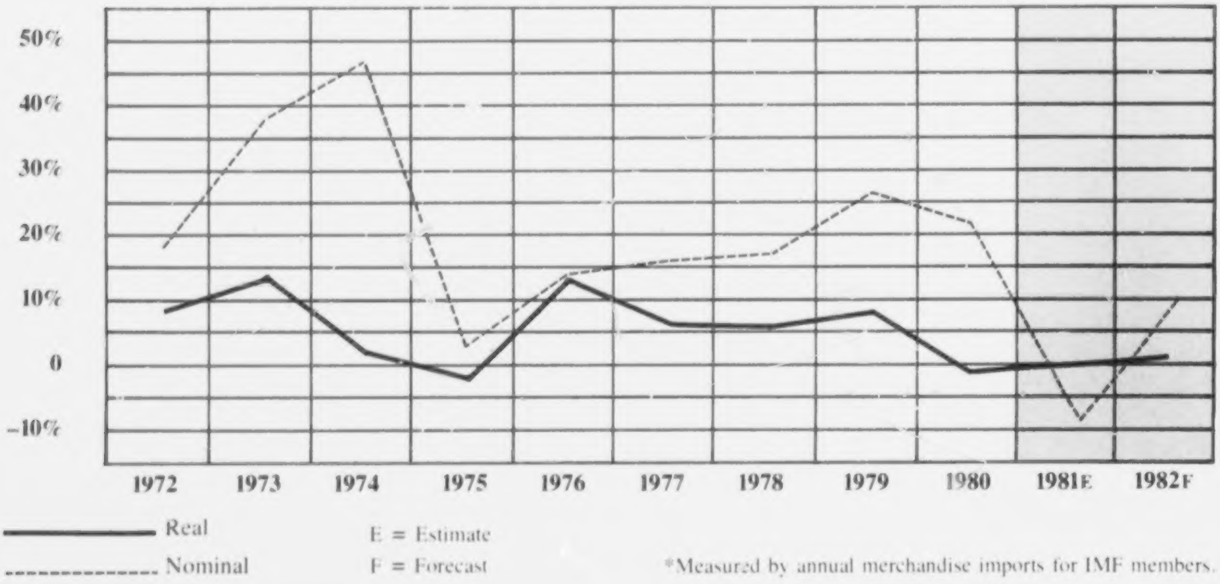
In 1982, import prices are forecast to rise approximately 7.9 percent. The greater increase in import prices in 1982 is a function of inflation rates in the exporting countries and changes in commodity prices in 1982 in comparison with 1981 levels. As indicated in the previous article, consumer prices in the OECD economies are forecast to rise 7.7 percent in 1982, after an estimated 9.1 percent increase in 1981, which indicates that export prices should, in general, rise at a lower rate also. Commodity prices, on the other hand, are expected to rise from 3 to 5 percent, in comparison with 1981's 14.5-15.5 percent decline. Commodity prices usually begin to rise only after a period of sustained, substantial real economic growth. Since growth in price-adjusted terms in the industrialized economies is not expected to increase until the second half of 1982, commodity prices are forecast to remain weak throughout 1982. Only in 1983 should commodity prices begin to strengthen significantly, everything else remaining the same.

Assuming that nominal trade increases 9.0 percent over 1981 levels, the value of world trade should equal approximately $1,925 billion in 1982, a $160 billion increase in comparison with year-earlier levels. The 7.0 percent annual increase in nominal trade, on a compound-rate-of-change basis, over the first three years of the 1980s, comprises mostly price increases. Whereas real trade should experience a 0.3 percent annual growth rate, prices should rise 6.6 percent annually.

The estimates for trade growth in 1981 and the forecast for 1982, which depend to a large extent on real economic growth in the industrialized economies, bear heavily on the outlook for the developing nations. The ability of the less-developed nations to continue to progress economically is enhanced if world trade grows vigorously; conversely, it is diminished if world trade stagnates or shrinks. In the following article, the outlook for the developing nations is presented.

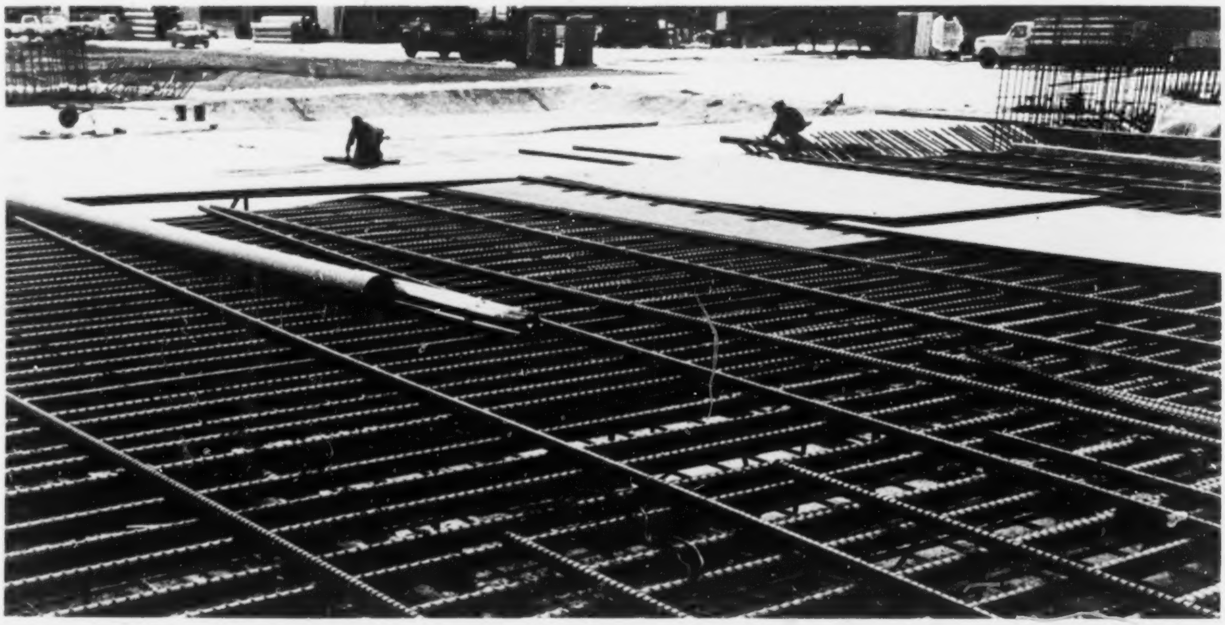
PERCENTAGE CHANGES IN REAL AND NOMINAL WORLD TRADE*

1972-1982



*Measured by annual merchandise imports for IMF members.

OUTLOOK FOR THE DEVELOPING WORLD



PERFORMANCE IN 1981

Going into the year 1982, it appears fairly clear that most of the economies of developing countries other than those belonging to OPEC have weathered the worst of the second "oil price shock" of the 1970s. The 1980 economic performance of the developing country group was recently described by the World Bank* as "remarkable," in view of the problems they had faced.

The same generalization could also be made of the performance of the group in 1981, once again considering external influences. The new round of oil price increases was over, but the world economic slowdown continued, deepening slightly, as was discussed in the article on the economic outlook of industrial countries.

The favorable assessment of the economic performance of developing world economies refers principally to their ability to increase aggregate output at a relatively strong pace. Real growth for the developing country group was 4.6 percent in 1980, only one half of one percentage point lower than in 1979. Even as the world economic slowdown spread in 1981, economic growth was maintained at more than a 4 percent rate.

Current-Account Trends

In other respects, however, the economic performance of the non-OPEC LDCs was not as favorable. The main strain was the large increase in the group's aggregate current-account deficit, together with the difficulties experienced by some countries in financing the deficit. In 1979, the aggregate current-account deficit of the group totaled only $42 billion. The deficit rose to an estimated $65.4 billion in 1980, and the outlook is for an $83.4 billion current-account gap for 1981.

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*The World Bank includes some members of OPEC in its developing country classification. Many calculations in this article are based on data published by the World Bank or the International Monetary Fund.

The large increases in the current-account deficit in 1980 and 1981 arose chiefly from trade trends. For the non-OPEC developing countries, the slow pace of growth in the industrial world meant, first, a slowing in the volume of world trade, which fell 0.1 percent in 1980. Next, in 1981, the prices of the commodities that developing countries export declined steeply, after they had risen for several years.

While overall export growth exceeded import growth in 1979, in 1980 the reverse occurred. Higher oil prices and higher prices for manufactured goods produced in industrial countries drove up import bills at the same time that falling commodity prices and dampened world trade growth resulted in slower export growth. Partial data for 1981 show an intensification of the trend. During the first quarter of 1981, both non-OPEC exports and imports grew fairly sluggishly; however, the growth of import expenditures was more than twice as great as that of export earnings. Imports were 11.9 percent above the first quarter of 1980, versus 4.5 percent growth for exports.

Among the explanations for the higher prices that developing countries paid for goods imported from industrial countries was the fact that, despite the slowing of economic growth, inflation in the industrial world remained high. This fact also produced another strong impact on the LDC group's external accounts. The persistence of inflation caused authorities in the major countries to maintain restrictive monetary policies, which supported the high rates of interest that prevailed in world financial markets in 1980 and 1981.

This interest-rate trend directly affected developing country payments on the large external debt of the group. As shown in the table on page 25, by the end of 1981 the disbursed public-sector medium and long-term external debt of developing countries should reach an estimated $299 billion, of which $123 billion is owed to private financial institutions. At the same time, private financial institutions should hold additional claims on developing countries totaling around $163 billion. This latter figure represents balances such as outstanding short-term public-sector debt, unguaranteed private-sector borrowings of all maturities, and bank placements. Interest due on virtually all the medium and long-term lending and many other transactions between private lenders and developing country borrowers fluctuates with international interest rates. Since bank claims on developing countries total $286 billion, at least $2 billion and possibly as much as $2.5 billion is added to the developing world's interest payments for each percentage point that international rates average above the level of the previous year.

The London Eurodollar rate averaged 2.4 percentage points higher in 1980 than in 1979, suggesting a considerable increase in the debt-servicing burden. The additional 3.1 percentage point increase in the average rate for the first nine months of 1981 clearly represented an intensification of the strain emanating from that source.

The large deteriorations in 1980 and 1981 in the developing country group's aggregate deficit on current account is estimated in the table on real economic growth and current-account trends. The substantial differences shown in regional patterns is also illustrated. Over two thirds of the developing world's current-account deficit was registered by the nations of the Western Hemisphere and of East Asia.

NON-OPEC DEVELOPING WORLD
REAL ECONOMIC GROWTH AND CURRENT-ACCOUNT BALANCES

	Real Economic Growth (Percentage Change)			Aggregate Current Accounts (Millions of U.S. Dollars)		
	1980	1981E	1982F	1980	1981E	1982F
Africa	2.3	2.0	3.5	−1,400	−7,750	−6,000
East Asia	2.6	6.7	7.0	−17,047	−20,699	−19,500
Mediterranean	1.4	2.5	3.5	−8,233	−8,500	−8,000
Middle East and North Africa	7.5	5.7	6.0	−4,470	−6,671	−5,950
South Asia	7.4	4.1	5.1	−4,020	−4,895	−4,400
Western Hemisphere	5.8	4.0	4.9	−30,191	−34,902	−35,950
All Non-OPEC LDCs	4.6	4.1	5.0	−65,361	−83,417	−79,800

E = Estimate F = Forecast

Groupings of developing countries according to income, their status as oil importers or exporters and their importance as manufacturers also record greatly disproportionate shares of the aggregate deficit. Illustrated in the chart are the percentage shares of the deficit of the developing world held by various groups, based on International Monetary Fund definitions and data published in its 1981 *World Economic Outlook*. The large share of the total accounted for by countries that are major exporters of manufactured goods, including Argentina, Brazil, Israel, South Korea, Portugal, South Africa, and others, illustrates that group's significant exposure to oil-price and world-market disruptions. Both 1975 and 1981 were years of slow trade and economic expansion worldwide, following rounds of major price increases for oil. Leading manufacturing LDCs accounted for well above 40 percent of the total deficit for these years. In 1978, a year of expanding trade and stable oil prices, that group's share of the deficit fell to 27.7 percent.

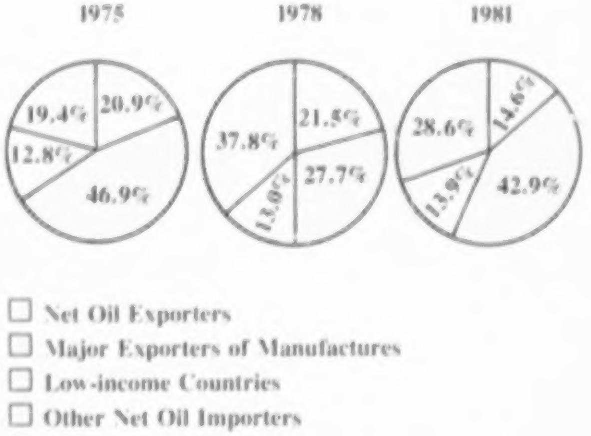
The table on page 25 illustrates the major avenues utilized by developing countries for financing their current-account deficits. The term "gross financial requirement" refers to the total flow of trade and financial resources into developing world economies. Principal repayments are also included as an indication of resources required to offset a drain on externally-generated liquidity from the developing world as existing debt is amortized. The developing world's gross financial requirement has not been rising as rapidly as its current-account deficit, since official foreign exchange reserves, and other claims on external financial institutions, have been rising more slowly. Official reserves actually declined in 1981.

Direct investment flows are important to the non-OPEC LDCs since they do not create direct repayment obligations. Borrowed resources, however, have come to be relied on most heavily for offsetting the gross financial requirements of the non-OPEC LDCs. Moreover, long-term loans from financial institutions to public borrowers have come to be the most important component of the financial flows to developing countries. Of significance in recent patterns was the lower volume of such inflows in 1980. The slowing resulted partially from lender reassessments of risk versus the very favorable terms and conditions some developing countries had enjoyed in the latter 1970s. Instead, the largest single offsetting movement in 1980 came to be changes in the asset position of international banks, other than changes in the public-sector, long-term debt outstanding. Hence, short-term and private capital movements assumed a relatively greater role in the adjustment process to the oil price/recession cycle of 1979-81 than it had played in 1973-75. The large increase estimated for 1981 in the use of reserve-related facilities, based primarily on the expanded lending capacity of the IMF, is also significant.

Inflation

A third indicator of the economic health of the non-OPEC LDCs is inflation. The 36.5 percent increase in consumer prices, on average, during 1980 was the largest ever recorded by the non-OPEC LDC group. The 1981 increase is estimated to be still larger, about 43.0 percent. Several factors helped produce the worsening trend. First, the oil price increases of 1979-1980 had a direct effect. In order to reduce import volume, several countries instituted large increases in fuel prices. Second, as discussed previously, inflation in industrial countries contributed to inflation in developing countries through trade. Third, economic policy in the developing world remained generally expansionary through 1980. The growth of domestic liquidity accelerated from 1978 through mid-1980.

SHARES OF AGGREGATE NON-OPEC DEVELOPING WORLD CURRENT-ACCOUNT DEFICIT PRODUCED BY MAJOR CATEGORIES OF COUNTRIES



After mid-1980, some moderating of the growth of liquidity occurred. That easing was followed by a reduction in the other pressures. Inflation in the industrial countries declined somewhat during the first half of 1981, and the midyear "oil glut" resulted in some softening of prices. These developments should have the effect of producing a significant decline in the rate of inflation during 1982 to below the 1980 pace, as illustrated in the table.

REGIONAL AND NATIONAL DIFFERENCES

The range of variation in average growth rates for GNP for the developing world is illustrated in the "real growth – current-account" table. Among the explanations for the varying records of individual countries and regions, unequal endowments of natural resources stand out prominently. Positions as exporters or importers of oil, in particular, have become vitally significant to the outlook for individual developing countries. Other important factors include the availability of arable land relative to population size, climate, and geographic accessibility or isolation from markets and transportation routes.

Additionally, the effects of economic, social, and political evolution of individual nations have influenced the LDCs' performance. These effects are manifested in, as examples, the comparative advantages with respect to international trade arising from diverse productivity trends, the degree to which individual economies have become reliant on exports, and the ability to maintain a political consensus resulting in appropriate and consistent economic management.

In the late 1960s and particularly in the 1970s, a favorable, or conversely, an unfavorable combination of the foregoing, had tended either to open or close new avenues to economic growth and diversification. Historically, a key constraint to the building of strong economies from the abundant potential found in many developing countries had been a shortage of capital, which made it difficult to obtain imported machinery and capital goods, to build industrial structures, and to improve the infrastructure. Beginning in the mid-1960s this constraint was eased for many developing countries having strong fundamental potential and good management through their improved access to external credit.

Africa

The economic performance of the nations of sub-Saharan Africa is consistently among the weakest of the developing world. The region contains some of the poorest countries along with one of the richest of the non-OPEC LDCs — South Africa. Although many African countries are rich in mineral resources and are important exporters of metals and other commodities, inadequate transportation systems and other infrastructure often hamper the development of this potential. Furthermore, earnings from commodity exports are affected by price fluctuations and worldwide industrial slowdowns. Finally, the region includes only one net oil exporter, the People's Republic of the Congo, and, hence, has been adversely affected by the recent round of oil price increases.

Other than in South Africa, moreover, progress in domestically-oriented economic sectors is influenced by a high dependence on agriculture and by the exposure of that sector to drought and other climatic problems. The effects of virtually all these constraints were apparent in 1980 and 1981. Real economic growth fell to 2 percent during the latter year — a per capita decline. The current-account deficit rose to nearly $8 billion from $1.4 billion in 1980, as South Africa's position turned from a substantial surplus to a large deficit, and as the situation of traditional minerals exporters deteriorated seriously.

East Asia

In contrast to the nations of sub-Saharan Africa, East Asia includes some of the developing world's most advanced economies. Most of the more dynamic economies, including Hong Kong, South Korea, Singapore, and Taiwan, are major exporters of manufactured goods. The economic growth that has been experienced by these nations has pushed East Asia's aggregate growth to the forefront of regional patterns. The prominence of exports of manufactured goods to the overall economic health of these nations, however, is reflected in current economic growth rates below their long-run averages and in their large current-account deficits.

The Philippines and the remaining nations of the region that continue to depend more heavily on commodities exports have similarly experienced less-favorable export trends over the last two years. Both categories of countries, moreover, have seen their terms of trade deteriorate as a result of oil price increases.

NON-OPEC DEVELOPING WORLD CONSUMER PRICES AND EXTERNAL PUBLIC DEBT

	Consumer Prices (Annual Increase)			External Public Debt (Millions of U.S. Dollars)		
	1980	**1981E**	**1982F**	**1980**	**1981E**	**1982F**
Africa	16.1	18.5	15.0	24,300	27,800	30,800
East Asia	19.9	16.6	16.0	37,800	46,900	56,300
Mediterranean	50.2	28.0	25.0	25,600	29,300	33,200
Middle East and North Africa	41.1	35.3	25.0	39,200	42,200	44,900
South Asia	11.6	14.0	10.0	23,500	25,700	27,700
Western Hemisphere	56.1	70.0	60.0	111,500	126,800	143,900
All Non-OPEC LDCs	36.5	43.0	35.0	261,900	298,700	336,800

E = Estimate F = Forecast

The economies of East Asia have generally been well managed. This factor, along with their generally industrious labor force and /or natural resource wealth, in addition to their relative advancement, have afforded them an opportunity to develop their potential more fully by drawing financial resources from abroad. Despite the strength of their export sectors, they consistently show large current-account deficits. As a result, the external debt of these nations is large, second only to the nations of the Western hemisphere.

The 1981 record is estimated to include a current-account deficit of around $21 billion. Economic growth, at 6.7 percent, is below that of recent years, when it often exceeded 8 percent. The growth rate, however, is more rapid than that of 1980, which was affected by South Korea's recession in which economic output declined 5.7 percent. That recession partially resulted from a contractionary policy response to the strong inflationary pressures that had accompanied South Korea's ambitious bid to diversify its economic and industrial structures in the late 1970s.

Mediterranean

The Mediterranean group of developing countries include Greece, Portugal, Turkey, and Yugoslavia; and they are among the most advanced countries typically included in the non-OPEC LDC group. Despite their strength they suffer from a variety of structural problems — lack of significant resources, inefficient agricultural sectors, lack of investment, and difficulty in managing their economies due to economic, social (in some cases, ethnic fragmentation), and political factors. Turkey has encountered significant problems in servicing its external debt and is experiencing low rates of economic growth due to the policies it implemented to cope with its current-account deficit and with inflation. Both Portugal and Yugoslavia are also currently operating with a restrictive economic policy.

Economic growth of the Mediterranean developing countries, at 2.5 percent in 1981, is somewhat better than in 1980, but it is far below the long-term 5.1 percent trend. The external accounts of the nations of the group, however, have already begun to stabilize, as shown by the fact that the deterioration in the aggregate regional current account was slight. Inflation has receded greatly from the 50 percent average for 1980.

Middle East and North Africa

Five countries in this region — Bahrain, Egypt, Oman, Syria, and Tunisia — are net oil-exporting countries, and the Middle East and North Africa is the only net oil-exporting region of the non-OPEC developing world. These nations also receive large amounts of developmental assistance from friendly nations (largely from OPEC members in the cases of several Arab countries, and chiefly from the United States in the cases of both Egypt and Israel). These two facts have tended to sustain relatively favorable growth trends in a region that is generally lacking in other resources and in arable land.

Economic growth slumped to 5.7 percent in 1981. The world "oil glut" was partially responsible. Some of the countries of the region, moreover, have been experiencing balance-of-payments pressures that have prompted them to implement fiscal cuts and other restrictive economic policies. The current-account deficit showed a large increase to $6.7 billion with slower export growth being the major contributor.

South Asia

The densely-populated nations of South Asia are struggling to improve living standards for their millions against numerous obstacles. Per capita incomes in these nations are the lowest of all developing-country regions. Their economies are heavily dependent on agriculture and the infrastructure is inadequate. The growth of export capacity has not kept pace with the need to import necessary industrial goods, such as cement and steel, and even food.

India and the other nations of the group, nevertheless, have significant resource endowments and potential for diversification, which they are attempting to further. Support from multilateral lenders has been and will continue to be important to the growth process, although the external debt of the nations of South Asia is the lowest of any developing-world regional group.

NON-OPEC DEVELOPING WORLD EXTERNAL FINANCIAL REQUIREMENTS AND SOURCES

(Billions of U.S. Dollars)

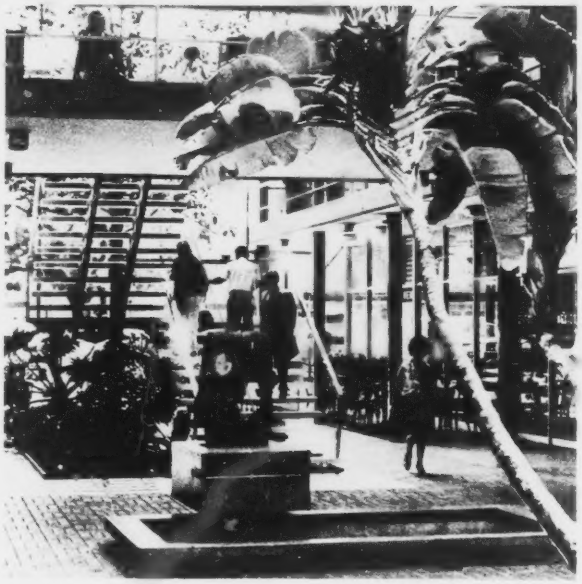
	1979	1980P	1981E	1982F
Aggregate Current-Account Deficit	42.0	65.4	83.4	79.8
Principal on Public-Sector, Long-Term Debt (to Private Financial Institutions)	24.8 (14.7)	26.5 (17.3)	29.4 (21.1)	34.6 (23.3)
Increase/Decline (–) in Official Reserves	8.4	0	–1.3	0
Change in International Bank Liabilities other than Official Reserves	8.7	7.9	5.0	5.0
Gross Financial Requirement	83.9	99.8	116.5	119.4
GROSS FLOWS				
Direct Investment	8.3	9.3	10.0	11.0
Portfolio Investment	1.5	2.0	3.0	3.0
Long-Term Loans to Public Sector				
From Governments	11.2	12.0	13.0	14.0
From Multilateral Institutions	7.7	8.9	10.2	11.7
From Suppliers	3.8	5.0	6.0	7.0
From Private Financial Institutions	35.5	25.0	34.0	37.0
OTHER FINANCIAL FLOWS				
Changes in the Asset Position of International Banks, other than Public-Sector, Long-Term Debt	20.9	38.4	32.8	32.7
Reserve-Related Facilities, net*	.2	3.0	7.5	3.0
Residual**	–5.2	–3.8	0	0
MEMORANDUM ITEMS				
Public-Sector, Long-Term Debt (Disbursed)	235.5	261.9	298.7	336.8
(to Private Financial Institutions)	(102.2)	(109.9)	(122.8)	(136.5)
International Bank Claims, other than Long-Term Claims on Public Sector	92.1	130.9	162.7	196.4

*IMF facilities and short-term loans between central banks.

**Gaps and errors in coverage, unrecorded items, understated reserves, etc.

P = Preliminary E = Estimate F = Forecast

Sources: World Bank, Bank for International Settlements



Economic growth in 1981 (4.1 percent) declined from 1980 rates, which, in turn, had represented a sharp resurgence from the drought-related decline in Indian economic activity in 1979. A modest deterioration in the current account to a $4.9 billion deficit was recorded in 1981, the result, largely, of the worsened terms on which the region's trade was conducted.

Western Hemisphere

The Latin American and Caribbean region includes several nations that are net oil exporters and several countries that are either nearly self-sufficient in oil or that have rapidly improving production/consumption ratios. In the first group are Bolivia, Mexico, Peru, and Trinidad and Tobago. Argentina and Colombia are nearly self-sufficient in oil production, and output/consumption ratios are improving in Chile and Brazil. Brazil is also making significant strides in its alternative-energy programs, especially in hydro-electricity and to a lesser extent alcohol-fuel for vehicles.

These developments augur well for the region's response to future oil price jolts. Recent economic developments, nevertheless, still reflect the problems of the oil price/world recession shock of 1979-81. Real economic growth in the region slowed to 4.0 percent in 1981, as both Brazil, the developing world's largest oil importer, and Mexico, the largest oil exporter, adopted policies designed to cope with inflation and large current-account deficits. Brazil's policy turn came after its deficit had already been bloated by expenditures on oil and by high interest payments. The fiscal cuts and import restraints implemented by Mexico were in response to the looming shortfall in oil export earnings due to the "oil glut."

Several of the important commodity exporting countries of the region, including Argentina, Chile, Colombia, and Peru, also were affected by falling prices for their exports. These declines impacted adversely on the growth records and external accounts of these economies during 1981.

The Western hemisphere nations include those nations that have relied most heavily on external capital sources. These nations are principally Brazil and Mexico, but they include several others. Their aggregate current-account deficit rose to nearly $35 billion in 1981, compared with $30 billion in 1980. The external public debt of the countries of the region at year-end 1981 is estimated at $126.8 billion, 42 percent of the public debt of all the non-OPEC LDCs.

1982 OUTLOOK

The problems faced by the nations of the developing world are forecast to ease in 1981, but they will not disappear. As will be discussed in the following article, oil price increases will be modest. The declining trend seen in commodity prices in 1981 will be reversed, but the gain will average only 3-5 percent. Finally, as the year advances, economic activity in industrial countries will strengthen.

These trends will have a favorable impact on key developing country indicators. The aggregate current-account deficit for the non-OPEC LDCs and the deficits of the various regions will narrow somewhat. Real economic growth rates will edge upwards, while the annual rate of inflation should average lower than in the preceding year for the first time since 1978.

The parallels between the problems of 1973-75 and those of 1979-81 are obvious. However, there were also significant differences, chiefly the fact that the process of adjustment to the most recent cycle was less onerous. Oil prices rose by a substantially smaller percentage in 1979-80 than they did in 1973-74, and the slowdown in the industrial world was more shallow. In 1981, when current-account deficits were at a recent high, the aggregate current-account deficit of the developing country group amounted to approximately 4.7 percent of its aggregate GNP, compared to 5.8 percent in 1975.

What may be significant when comparing the ways in which the non-OPEC LDCs responded to the challenges of the two periods is the evidence that the economies of the developing world are becoming more fundamentally resilient. Part of this greater resiliency comes from greater export diversity. The developing world still relies on commodity exports, but the importance of these exports currently is significantly less than it was in the 1970s. A comparison of data in a 1980 study by the National Foreign Assessment Center with data from the IMF shows that in 1978, more than a third of developing-country exports to industrial countries were manufactured goods, compared with 27.2 percent five years previously. Manufactured goods exports to such countries alone accounted for 21.0 percent of their total exports that year, 3.4 percentage points more than in 1973. Developing countries had captured 20.8 percent of the lucrative U.S. market for imported manufactured goods and 22.6 percent of that of Japan. Although the trend is more difficult to measure, developing-country exports of manufactured goods to other developing countries have also been expanding rapidly.

Somewhat paradoxically, the overall dependence of the developing world on exports to industrial countries has actually decreased. This decrease resulted from, first, the proportional shift away from traditional goods towards manufactured goods and, second, from the greater geographic diversification of markets.

Between 1973 and 1980, the proportion of developing-country exports going to the United States declined from 19.0 percent to 18.3 percent, whereas the proportion destined for the EEC fell from 28.4 percent to 24.4 percent. Conversely, exports to the oil exporting group of countries accounted for only 3.1 percent of developing world exports in 1973; but by 1980, the proportion had more than doubled to 6.3 percent. Markets in other non-OPEC developing countries expanded from 20.3 percent in 1973 to 23.8 percent in 1980.

Additionally, the record of the past decade, especially the adjustment of the non-OPEC LDCs to the two oil shocks, has revealed a strong capacity to manage large external debts. The borrowings undertaken by these nations during the 1970s caused the total long-term external debt of their public sectors alone to rise to around $300 billion by the end of 1981. Of this amount over $123 billion was owed to private financial institutions. Additionally, these institutions held some $163 billion in other claims against borrowers in non-OPEC developing countries, chiefly public-sector, short-term loans and loans to private borrowers.

To many observers these large totals indicate a dangerous over-extension of the borrowing and repayment capacity of the non-OPEC LDCs, particularly when the numbers are compared with a public-sector debt of less than $100 billion in 1973. However, it should not be overlooked that other important developing country aggregates — particularly exports and overall economic output — have shown similar rates of increase. In its 1981 *World Economic Outlook*, the IMF found, for example, that in 1981 the ratio of the external public debt of the non-oil developing countries to their exports was 96.1 percent, only 6.8 percentage points higher than in 1973, after having peaked at 109.9 percent in 1978. Similarly, the ratio of the debt to the group's aggregate GNP rose from 16.7 percent in 1973 to 23.7 percent in 1978, from which it has declined to an estimated 20.9 percent in 1981. The debt-service ratio followed a similar pattern, rising from 24.8 percent in 1973 to 32.6 percent in 1979 and falling to 26.6 percent in 1981.

The foregoing presentation of key indicators of the debt-management record of the group as a whole is not to assert that certain individual nations have not experienced problems in servicing their debts. In some cases the severity of the problems experienced has necessitated negotiations with private and official lenders, leading to formal re-scheduling arrangements. Several recent debt-relief agreements are presented in the table on debt relief. Information in the table is divided into listings of re-schedulings completed by the so-called "Paris Club" and by commercial banks. The "Paris Club" is an informal arrangement whereby representatives of the major Western creditor countries meet with a debtor country — at the latter's initiative — to consider the postponement of servicing obligations on certain portions of the debt owed to those governments. Amounts shown in the case of the private bank re-schedulings are the actual amounts negotiated. In the case of "Paris Club" reschedulings, the amounts are our own estimates of the amortization payments due on debt owed to the "Paris Club" nations during the year of the agreement.

In conclusion, it is easily demonstrated that the non-OPEC developing nations remain closely linked to broader world economic trends and are, hence, vulnerable to world economic slowdowns and interest-rate volatility. Moreover, many important countries remain exposed to the adverse impact of further oil price increases. It is clear, nevertheless, that this vulnerability has decreased. The economic performances of the non-OPEC countries during 1980-81 may perhaps be a milestone in their advancement toward fundamentally stronger and more diversified economies. Available data support such optimism. What is needed is a new period of calm — a time without oil price shocks and other disruptive influences. Such a period would give the trends and developments that have already moderated the developing world's vulnerability to such influences an opportunity to flourish.

DEBT RELIEF EXTENDED TO NON-OPEC DEVELOPING COUNTRIES

(Millions of U.S. Dollars)

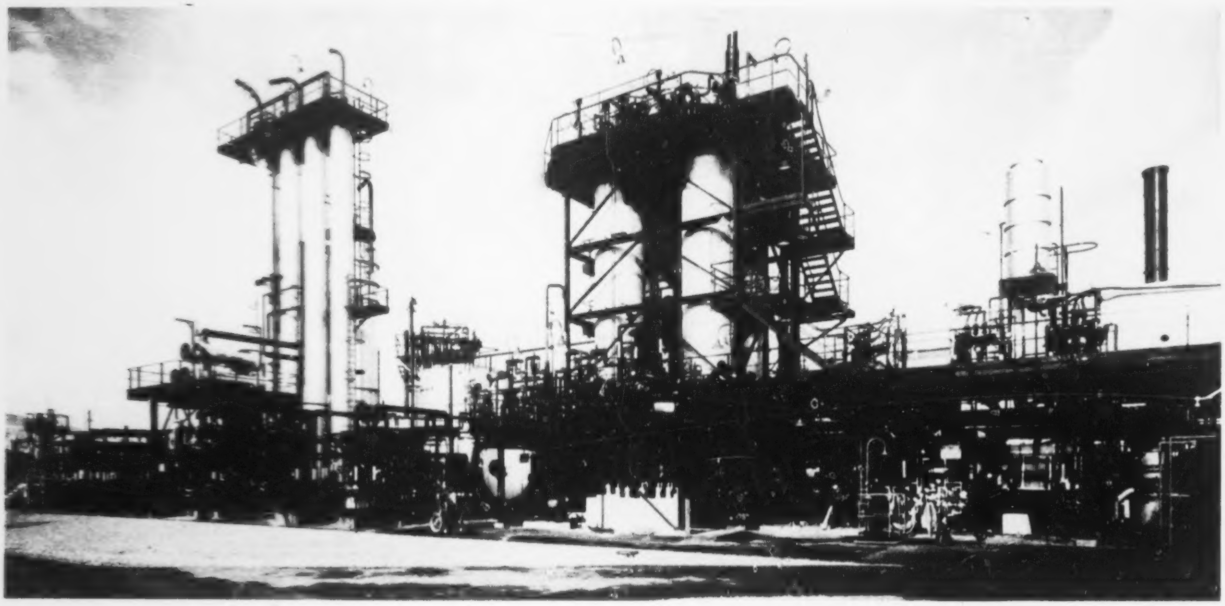
"Paris Club"			Commercial Banks		
COUNTRY	**MONTH**	**AMOUNT**	**COUNTRY**	**MONTH**	**AMOUNT**
1979					
Togo	June	3	Jamaica	April	450
Turkey	July	277	Turkey	August	529
Sudan	November	53			
Zaire	December	36			
1980					
Sierra Leone	February	2	Zaire	April	400
Turkey	July	377	Bolivia	September	460*
Liberia	December	6	Sudan	November	450**
			Nicaragua	December	582
1981					
Pakistan	January	186	Bolivia	April	460*
Togo	February	7	Jamaica	July	103
Madagascar	April	6	Nicaragua	October	180
Poland	April	2,500***	Costa Rica	Pending	860
Central Africa Republic	June	2	Liberia	Pending	N.A.
Zaire	July	81	Poland	Pending	2,400
Uganda	November	20	Sudan	Pending	450**
Costa Rica	Pending	9	Turkey	Pending	3,200
Senegal	Pending	11			

*A preliminary agreement was reached in 1980, but was re-negotiated in 1981.

**An agreement in principle was reached with the steering committee in 1980, but debt relief is still not final.

***As indicated in the text, the "amount" shown for "Paris Club" negotiations are SPNB estimates of principal due during the indicated year on the relevant portion of the government debt. However, in the case of Poland, which does not participate in the World Bank debt reporting system, the amount shown is the actual amount under negotiation.

OUTLOOK FOR OIL PRICES AND OPEC



In 1973, the average price of a barrel of crude oil from the Organization of Petroleum Exporting Countries (OPEC) was $3.39.* By the middle of 1981, the average price increased to $34.66 per barrel. This price rise represented a tenfold increase in just eight years. As a result of this oil price increase, the total OPEC current-account surplus is estimated to equal $375 billion between 1973 and 1981.

Developments in OPEC have dramatically influenced, both directly and indirectly, the oil importing countries. In an attempt to reduce their current-account deficits, which partially resulted from the oil price increases, the industrialized countries implemented deflationary policies, causing slower economic growth. Less-developed countries significantly increased external borrowing to finance their current-account deficits while attempting to maintain continued high rates of economic growth. In addition to these effects, the oil price increases have substantially reduced the quantity of oil demanded.

Slower economic growth and past decreases in the quantity of oil demanded are having a distinct impact on the current situation in world oil markets. Increases in the official price of OPEC oil have slowed, and the average spot price has declined. The oulook for 1982 is for stable nominal oil prices averaging approximately $34.50 per barrel.

The remainder of this article will examine the political events and economic forces that currently influence the price of oil and OPEC's current-account balance. The deployment of the OPEC surplus will also be examined.

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*The current members of OPEC are Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela.

OIL PRICE DEVELOPMENTS

The first major crude oil price increase occurred during the years 1973 and 1974. OPEC had become increasingly dissatisfied with previous pricing-and-royalty arrangements with the international oil companies and unilaterally increased the price of oil over the two-year period from an average price per barrel of $3.39 to $11.28. Previously, the posted crude oil price and royalties were directly negotiated with the international oil companies. The higher price and the resulting slower rate of resource depletion were an attempt to maximize the present value of the future revenues from the exporting countries' crude oil reserves.

Higher prices combined with world recession constrained the growth of demand for oil between 1975 and 1978. Increasing non-OPEC crude oil supplies from Mexico, Alaska and the North Sea also caused nominal oil price rises to decelerate. Real oil prices actually decreased during this period. Two ten-percent increases in nominal prices occurred during 1975 and 1976. Nominal crude oil prices remained relatively level during 1977 and 1978. The average official OPEC crude oil price for 1978 was $12.93 per barrel.

Political and military events during 1979 and 1980 caused the second major increase in the price of crude oil. Early in 1979, strikes in Iran caused oil production to fall from 5.8 million barrels per day (b/d) to 235,000 b/d. This low level of production was less than the domestic quantity demanded at current prices. Saudi Arabia tried to offset some of this lost output by increasing production from 8.5 million b/d to 10 million b/d. By the fall of 1979, the Islamic revolutionary government had replaced that of the shah, and production was increased to 4 million b/d. Saudi Arabia was then producing 9.5 million b/d. The net effect was a decrease in total OPEC crude oil production of approximately 1 million b/d. This supply reduction combined with increased demand induced by political uncertainty in the Middle East raised spot market oil prices above the $40 per-barrel level by fall 1979. The official OPEC marker price rose 95 percent from $13.34 to $26 per barrel.

Demand for oil, particularly in the spot market, remained strong during the last quarter of 1979 and first half of 1980, because international oil companies were building up oil inventories to maximum levels. When the supply disruption occurred during the Iranian revolution, inventories were low and serious allocation problems took place within the international oil companies. Since Middle East political uncertainty was still high and another supply disruption possible, international oil companies planned to maintain maximum inventories. Once this inventory build-up was completed by mid-1980, spot oil prices declined from their $40 plus per-barrel level to approximately the OPEC official price of $32 per barrel by September 1980.

In September of that year, however, war began between Iran and Iraq, which caused both Iran's and Iraq's oil production to drop significantly. Iraqi production in 1980 dropped 85.7 percent from an average of 3.5 million b/d during the first three quarters to 0.5 million b/d during the fourth quarter. Iranian production decreased 37.5 percent from an average of 1.6 million b/d during the first three quarters of 1980 to less than 1 million b/d during the fourth quarter. This 4 million b/d decrease in production combined with some speculative buying pushed spot market crude oil prices above $40 per barrel by November 1980. World recession and price-induced decreases in quantity demanded resulted in a worldwide excess supply of crude oil at then current prices. This excess supply eventually caused spot crude oil prices and exporting-country oil revenues to drop dramatically.

By mid-1981, the average spot crude oil price had declined below official OPEC prices. In June, the average official price was $34.77 per barrel while the average spot-market price was $31.43 per barrel, which represented a $3.34 per-barrel discount in the spot market. Initially, OPEC members with higher-priced oil began to lower prices unofficially by providing more favorable credit terms for its customers. This tactic did not significantly increase their crude oil exports. By early October, Nigeria cut the price of its premium African light crude oil to $34.50 per barrel from $40 per barrel.

This significant downward price pressure in world crude oil markets led to an emergency meeting of OPEC oil ministers in October, and a new unified pricing structure was approved. The official price of Arabian light crude oil increased $2 per barrel to $34. Price differentials based upon oil quality and locational differences were set at a maximum of $4 per barrel. Also, the entire price structure was to be frozen through 1982. As a result of this agreement, the average price of a barrel of OPEC crude oil increased $.50 per barrel to approximately $34.25.

IMPLICATIONS FOR FUTURE OIL PRICES

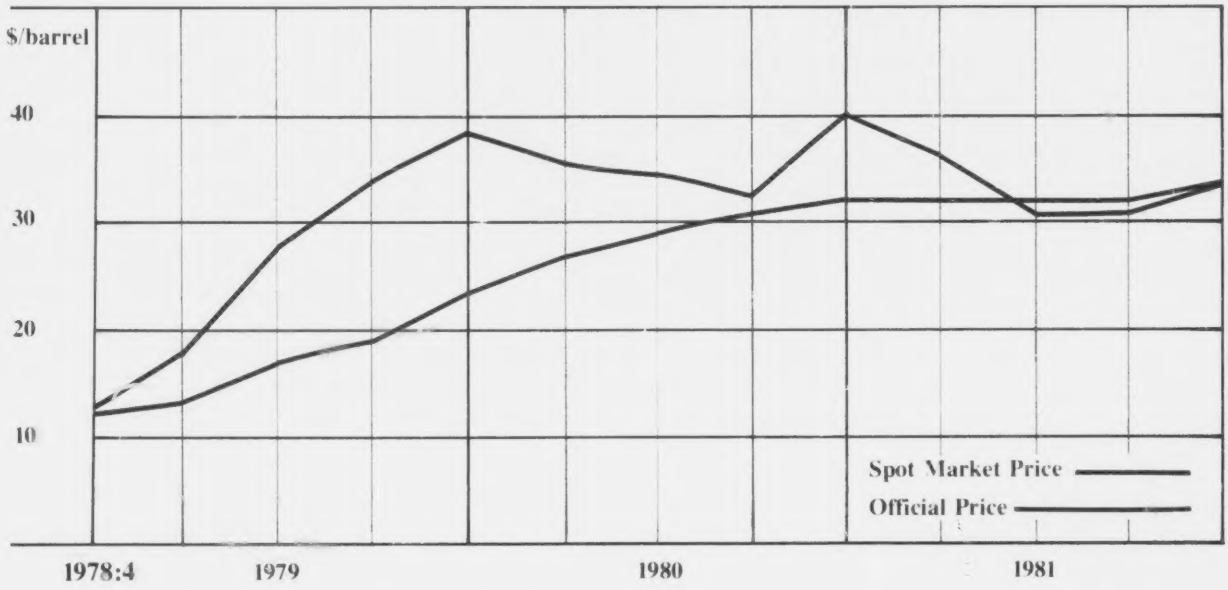
The increase in the price of crude oil has dramatically altered the future quantity of oil and oil substitutes supplied and demanded. Within the industrialized economies of the world, the quantity of crude oil demanded has declined significantly since the second oil-price increase in 1979-80. The total quantity of oil demanded decreased 7.5 percent in 1980, 5 percent in 1981, and it is expected to drop another 3 or 4 percent in 1982. This decline should be compared with the oil-demand response following the 1973-74 price increase. During 1973 and 1974, the quantity of oil demanded decreased 7.8 percent, the result of a 232.7 percent increase in average oil prices and world recession. Then, between 1975 and 1979, the quantity of oil demanded increased an average 11.5 percent per year. This increase was primarily due to falling real oil prices and a moderate recovery in the industrialized economies. The demand-pattern changes in 1980 and 1981 appear to be longer lasting. But for this trend to continue, real oil prices would have to increase in the future.

As the price of crude oil increases relative to other energy sources, households and firms tend to shift energy expenditures away from oil toward other energy sources and oil-saving items. Furthermore, the change in the quantity of oil demanded that results from an increase in price is greater in the long run than short run. As a result, a general increase in total energy efficiency is occurring. This increased energy and oil efficiency results in a decrease in energy intensity, the amount of total energy measured in oil equivalents needed to produce $1,000 worth of GNP. For the industrialized economies, it took approximately 4.5 barrels of oil equivalents in 1973 to produce $1,000 worth of GNP. By 1980, energy intensity had decreased to 4 barrels.

The value of the U.S. dollar can also influence the price of oil in the importing countries, particularly Europe and Japan. Since OPEC oil was priced in and purchased with U.S. dollars, the appreciation of the U.S. dollar vis-a-vis most European currencies during the first three quarters of 1981 has raised the effective price of oil in Europe. The price of a barrel of oil increased an average of $8 per barrel in Europe because of the appreciation of the U.S. dollar, which contributed to the decrease in the quantity of oil demanded in Europe during 1981.

Declining economic growth has also contributed to decreasing oil demand. Between 1965 and 1973, economic growth among the industrialized countries

ACTUAL SAUDI LIGHT CRUDE OIL PRICES
(End of Quarter)



averaged 5 percent per year, and the rate has declined since 1973. The primary causes of this decline were lower labor-force growth rates, decreased productivity growth, and higher oil prices. Since the rapid growth rates of the 1960s and early 1970s do not appear likely to return soon, growth in total oil demand for the industrialized countries should be lower in the early 1980s than in the 1970s.

The rate of economic growth among developing economies has been higher than in the industrialized economies of the world. During the period of 1965 to 1973, the developing economies' growth rates averaged slightly more than 6 percent per year. Between 1973 and 1980, they averaged 5.2 percent per year. Economic growth rates beyond 1980 are likely to be lower than during the 1970s but still greater than for the industrialized economies. The higher economic growth rates frequently combined with domestic price controls on oil and oil-related products result in oil demand increasing at a faster rate than in the industrialized economies. Domestic price controls keep the prices for these products artificially low and increase the quantity of oil demanded.

Estimates of future annual growth rates for energy demand, of which oil is the main component, are as high as 6 percent. Such rates would represent an increase over the historical average of approximately 4.5 percent per year. Roughly 75 percent of this future growth in oil demand among developing countries will come from the oil-exporting developing countries, which have been trying to diversify their economies away from crude oil production.

Higher relative real crude oil prices between 1973 and 1980 reduced energy intensity in the industrialized economies. In developing countries, energy intensity averaged approximately 3.9 barrels of oil equivalents per $1,000 of GNP between 1973 and 1977. From 1977 to 1980, their average energy intensity increased to 4.1 barrels of oil equivalents per $1,000 of GNP. This rising trend was due to domestic price controls on oil, rapid industrialization and urbanization in these countries. Clearly, to improve the efficiency in oil and general energy usage, decontrol of domestic energy prices will be necessary. All of these factors will cause approximately 50 percent of future increases in total oil demand to come from the developing economies group.

The proven crude oil reserves of OPEC have been estimated to equal 390 billion barrels in 1980, which represents 60 percent of the world's proven crude oil reserves estimated to equal 642 billion barrels. Proven crude oil reserves in Saudi Arabia equal 166.5 billion barrels Saudi reserves, the largest single country total in the world, constitute 42.7 percent of the OPEC total and 25.9 percent of the world's proven crude oil reserves. (All reserve estimates use current prices and hold technology constant.)

Current OPEC crude oil production equals 22.9 million b/d, which represents a 25.9 percent decrease since 1973 and a 26.6 percent decrease since output peaked at 31.2 million b/d in 1977. Currently, there is approximately a 12 million b/d excess capacity. This lower level of production is caused primarily by decreased crude oil demand in the industrialized countries, revolution in Iran, and the Iraqi-Iranian war.

However, now OPEC faces an increase in competition from other suppliers. Higher prices have stimulated extensive crude oil exploration. Significant new reserves have been found in Mexico and other — primarily developing — countries. Furthermore, production has expanded in Mexico, the North Sea and Alaska. Crude-oil price decontrol in the United States appears to have caused production to level off, halting the recent downward trend. U.S. output in 1979 was 9. 6 million b/d, and total non-OPEC supply was 20.1 million b/d, which has since increased 11.9 percent to 22.5 million b/d in 1981.

Finally, the increase in the price of crude oil relative to other energy sources has caused an increase in demand for crude oil substitutes. This shift in relative demand has significant effects on oil's share of total energy supply now and in the future. Between 1965 and 1973, the total supply of oil increased 7.7 percent per year; the supply of natural gas increased 7.3 percent annually, coal, 1.0 percent; nuclear power, 27.8 percent; and other sources, 3.9 percent. Between 1973 and 1979, crude oil supply increased 2.2 percent annually; natural gas, 7.3 percent; coal, 2.4 percent; nuclear power, 20.9 percent; and other sources, 4.6 percent. Hence, a clear shift away from crude oil to other energy sources occurred. Coal and nuclear power were the big gainers in this period. The analysis above illuminates several clear trends, which have significant implications for future prices of crude oil and OPEC.

Oil-demand growth exceeded total energy-demand growth before 1973. Since 1973, oil demand has grown less than total energy demand. Most of the decrease has taken place in the industrialized economies. This trend appears likely to continue unless real oil prices decline

significantly. Also, when the industrialized economies begin to grow faster in late 1982, oil demand will experience a small increase. The primary source of future crude oil demand growth comes from the developing economies.

Non-OPEC crude oil supply has increased over the last few years. By 1980, it accounted for approximately 50 percent of the total. Because of the decrease in demand and increase in non-OPEC supply, OPEC crude oil production should remain near the 1981 level of 22-24 million b/d in 1982.

Oil in general will claim a smaller share in the world's future total energy supply because the price of oil has increased relative to other energy sources. But even with all of the above adjustments, oil will remain the largest single energy source in the near future.

All of the supply and demand factors point toward a leveling off or only gradual increases in future oil prices. In 1982, average nominal crude oil prices should remain fairly stable around $34.50 per barrel. Real oil prices will decline. Beyond 1982, real oil prices should *gradually* rise over time, assuming no major supply disruptions occur.

Over the last few years, the Saudi Arabian government has unsuccessfully proposed a long-run OPEC crude oil pricing policy. It has argued that over the long run, the price of crude oil should increase at a rate equal to the return on alternative assets adjusted for inflation and U.S. dollar exchange-rate fluctuations. This policy would result in maximizing the wealth of Saudi Arabia and OPEC over the life of their oil reserves. The Saudi government realizes that the increase in the relative price of oil has two effects, neither of which is in its best interest. First, the quantity of oil demanded declines, and second, the use of oil substitutes is encouraged. Also, the Saudis have substantial investments in oil-importing countries, so they prefer a more stable world economy. Finally, the Saudi long-run crude oil pricing strategy would appear to be consistent with some of the foreign-policy concerns of moderate OPEC members. Maintaining good political relations with the oil-importing Western economies, particularly the United States, can strengthen their military position relative to the Soviet Union and other, more radical countries.

OPEC has been unable to reach agreement on this issue because it is not a completely homogeneous group of countries with identical economic structures and goals. The members of OPEC can be classified into three different groups: high-, low- and medium-absorbing countries. The low-absorbing countries such as Saudi Arabia, have larger crude oil reserves and relatively smaller populations compared to the other groups. Since they do not spend all their oil revenues on imports and their crude oil reserves have a long lifetime, they prefer a more moderate pricing policy. The high-absorbing countries have smaller crude oil reserves and larger populations compared to the low-absorbing countries. Since their reserves have a short lifetime, they want high current oil prices to finance their ambitious economic development programs. Medium-absorbing countries have characteristics of both other groups, larger populations than the low-absorbing countries and larger crude oil reserves than the high-absorbing countries. They, like the high-absorbing countries, prefer high current oil prices to finance their economic development programs.

THE OPEC BALANCE ON CURRENT ACCOUNT

The aggregate OPEC current-account balance has been heavily dependent on the growth in crude oil prices and export volume. Rapid economic development programs directed at diversifying the industrial and agricultural sectors of the economy have also stimulated import growth.

The aggregate OPEC current account reached record surpluses in 1974 and 1980. Between 1973 and 1974, crude oil price increases caused an aggregate current-

OPEC CURRENT-ACCOUNT BALANCES
(Millions of U.S. Dollars)

	1977	1978	1979	1980	1981E	1982F
Algeria	−2,324	−3,539	−1,730	−592E	−1,268	−1,451
Ecuador	−341	−701	−617	−3,106	−1,100	−1,000
Gabon	31	74	245	570E	375	401
Indonesia	−50	−1,414	980	2,863	−1,655	−3,005
Iran	5,082	1,275E	9,925E	−1,834E	−2,153	−2,426
Iraq	2,990	2,945E	7,083E	6,814E	−4,187	−4,719
Kuwait	4,766	6,193	12,281	15,799	13,650	11,916
Libya	3,293	2,121	7,365	14,303E	8,429	7,215
Nigeria	−1,016	−3,782	1,224	4,254E	1,547	1,324
Qatar	633	980	1,328	3,530E	2,405	2,482
Saudi Arabia	12,692	−1,025	10,856	43,823E	38,965	34,397
U.A.E.	1,988	1,766	5,408	10,069	6,330	6,533
Venezuela	−3,182	−5,736	350	4,240	3,300	2,300
Total	24,562	−843	54,698	100,733	63,638	53,967
Low Absorbers	20,079	7,914	29,873	73,221	61,350	55,328
High Absorbers	−6,882	−15,098	452	8,229	1,199	−1,431
Medium Absorbers	11,365	6,341	24,373	19,283	2,089	70
Total	24,562	−843	54,698	100,733	63,638	53,967

E = Estimate F = Forecast

account surplus of $63.4 billion in 1974, which was approximately forty-four times greater than the 1973 surplus of $5.3 billion. World recession in 1975 combined with a rapid increase of imports into the oil-exporting countries caused the surplus to decline. Total OPEC import volume grew 40 percent in 1974 and 43 percent in 1975. Small nominal crude oil price increases during the period 1975 to 1978 and the moderate recovery within the oil-consuming economies continued to reduce the growth of OPEC's oil export revenues. These factors combined with positive growth rates in import volume caused the aggregate OPEC current-account surplus to decline and become negative by 1978. The aggregate OPEC current-account deficit in 1978 was $843 million. Declining crude oil export revenues and infrastructure bottlenecks caused import growth by volume to decline 12.0 percent in 1979.

The declining trend in the aggregate surplus reversed itself by the end of 1979, when a major crude oil supply disruption occurred due to the Iranian Islamic revolution in 1979 and the Iraqi-Iranian war in 1980. OPEC's total production of crude oil decreased approximately 1 million b/d due to the revolution. The war caused crude oil production to drop another 3 to 4 million b/d. Part of this was offset by increased production in Saudi Arabia. The decrease in supply combined with a growing demand due to a major oil inventory build-up by international oil companies caused prices to increase 65.3 percent during 1979 and 1980. The official Saudi light crude oil price rose to $32 per barrel.

Spot-market crude oil prices reached levels in excess of $40 per barrel. The result of this second major oil price increase was a $54.7 billion current-account surplus in 1979 and a record $100.7 billion surplus in 1980. The oil-exporting countries were able to increase significantly imports and maintain a large aggregate current-account surplus.

The outlook is for the 1981 and 1982 aggregate OPEC current-account surplus to continue but decline. The 1981 aggregate surplus is estimated to equal $63.6 billion, a 36.8 percent decrease from 1980. The 1982 aggregate surplus is forecast to equal $54.0 billion, a 15.1 percent decrease from the 1981 estimate.

The declining aggregate current-account surplus results from a number of factors. First, economic growth within the oil-importing countries has been flat in 1981. For 1982, economic growth is forecast to equal 1.6 percent for OECD countries and 5.0 percent for developing economies. This limited recovery has a moderating effect on crude oil demand growth and oil prices. Second, the high oil prices in 1980 have caused a tremendous decline in the quantity of oil demanded. Conservation of oil usage combined with the substitution of alternate energy sources has caused this decrease in consumption. Third, oil supplies have increased from non-OPEC sources. Finally, OPEC imports continue to expand as each member attempts to diversify and develop its own economy's industrial base. Assuming no major supply disruptions in the near future, the clear trend is for a declining aggregate OPEC current-account surplus.

For the remainder of this section, the members of OPEC will be broken into three basic groups: high-, low- and medium-absorbing countries. The high-absorbing countries are Algeria, Ecuador, Gabon, Indonesia, Nigeria, and Venezuela. The low-absorbing countries are Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates. Finally, Iran, Iraq, and Libya are classified as medium-absorbing countries. This last classification has been distorted recently by the continuing war between Iraq and Iran. A discussion of each group's current-account balance and outlook follows.

The total current-account surplus for the low-absorbing members increased to $73.2 billion in 1980, a 145 percent increase from the 1979 level of $29.9 billion. This jump in their current-account surplus was the result of the 65.3 percent rise in average crude oil prices between 1979 and 1980, and it occurred while imports of the low-absorbing countries grew an average 19.7 percent in 1979 and 15.8 percent in 1980.

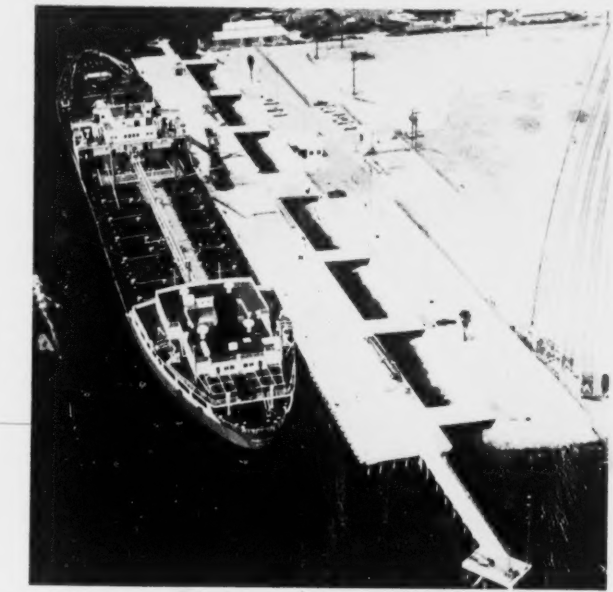
The future trend in this group's current-account surplus is similar but less dramatic than the aggregate OPEC current-account position. The surplus is estimated to have decreased in 1981 to $61.4 billion, which represents a 16.0 percent decrease from the 1980 level. The decline was less than the 36.7 percent fall estimated for the aggregate OPEC current-account surplus. In 1982, the low-absorbing countries' current-account surplus is forecast to decrease 9.9 percent to $55.3 billion, which is also less than the 15.1 percent decrease forecast for the aggregate OPEC current-account surplus.

Saudi Arabia, OPEC's largest crude oil exporter and the major low-absorbing country, had a record current-account surplus of $43.8 billion in 1980. The surplus is expected to decline approximately 11 percent per year in both 1981 and 1982, the result of softening oil prices and increased imports of goods and services. The other low-absorbing countries, Kuwait, Qatar, and the United Arab Emirates are not expected to experience as significant a deterioration in their current-account positions in 1981 and 1982.

The high-absorbing economies have run significantly smaller current-account surpluses than the low-absorbing countries. Their combined surplus was $8.2 billion in 1980, which compares with a $73.2 billion surplus in the low-absorbing countries. The 1981 surplus for the high-absorbing economies is estimated to have declined 85 percent to $1.2 billion. For 1982, their current-account balance is forecast to switch to a $1.4 billion deficit. The effects of reduced crude oil export revenues and rising imports result in this rapid elimination of their 1980 surplus.

This group has been hard hit by the decrease in oil demand. For most of 1981, Algeria and Nigeria maintained high prices near $40 per barrel for their high quality light African crude oil. As a result, oil production and export sales deteriorated dramatically in 1981. Their current-account balances are not expected to deteriorate as much in 1982. Both countries adjusted their crude oil prices down to below $38 per barrel in late 1981, which should cause oil exports revenues to level off in 1982.

For the other members of the high-absorbing group (Gabon, Venezuela, Ecuador, and Indonesia), current-account forecasts vary for 1981 and 1982. Both Venezuela and Gabon will experience a slight deterioration



in their current-account positions but should maintain surpluses in 1981 and 1982. Ecuador and Indonesia should incur current-account deficits in 1981 and 1982. Indonesia's deficit deteriorates dramatically while Ecuador's remains at about the same level each year.

Iran, Iraq, and Libya have been classified as medium-absorbing countries. As a group, they maintained a current-account surplus over the entire period examined. The surplus has been, and is expected to be, smaller than the low-absorbing countries' balance but larger than the high-absorbing countries' balance in any given year.

In 1980, the year of the record aggregate OPEC current-account surplus, the medium absorbers had a $19.3 billion surplus, which compares with a $73.2 billion surplus for the low-absorbing countries and $8.2 billion surplus in the high-absorbing countries. The estimated 1981 surplus declined substantially to slightly more than $2 billion. For 1982, a $70 million surplus is forecast.

The reasons for this deterioration vary from country to country. For Iran and Iraq, revolution and war have caused crude oil production to drop significantly since 1980, causing a large loss in oil export revenues. The forecast for Libya is similar to the pattern of Algeria and Nigeria. Libya maintained high crude oil prices, and oil export revenues fell significantly in 1981. The forecast assumes Libya lowered its price below $38 per barrel in the fourth quarter of 1981, which should cause export revenues to level off in 1982 and end the accelerated deterioration in its current-account position.

RECYCLING THE OPEC SURPLUS

Between 1973 and 1979, the total aggregate OPEC current-account surplus is estimated to have equaled approximately $211 billion. The tremendous size of this surplus poses several crucial questions. For example, where has this large supply of financial capital been invested? Can the world's international money markets continue to recycle this large a sum?

To add some perspective, if the entire surplus were invested in only OECD stocks and bonds, it would represent 5 percent of the total. If it were invested only in OECD fixed assets, it would account for 2 percent of the total. By viewing the aggregate surplus in this manner, it is clear that the surplus represents a small percentage of total world assets. The world economy should have little difficulty investing the rapidly declining OPEC surplus.

The portfolio managers of the OPEC countries have generally preferred to remain fairly liquid and have invested the majority of their wealth in short-term assets, primarily bank time deposits. They have also shown a preference for concentrating their investment in the more stable industrialized economies such as the United States and the United Kingdom.

Since the end of 1974, the Bank of England has continually monitored and estimated the deployment of the aggregate OPEC current-account balance by type of asset. It estimates that the asset composition of the OPEC portfolio at year-end 1979 was allocated as follows: approximately 49 percent was invested in large bank deposits (77 percent in Eurocurrency deposits, 23 percent in ordinary bank time deposits), and 7 percent in government securities (3 percent was in short-term instruments). Roughly 20 percent represented loans and aid directed at non-oil exporting developing economies, which included funds at the IMF and World Bank. The other 24 percent remained unidentified. A substantial portion of the remainder may have represented purchases of gold.

In terms of country placement, by the second quarter of 1981, 24.1 percent was located in the United Kingdom and 23.5 percent in the United States. The rest of the world received the remaining 52.4 percent.

In conclusion, a number of significant trends should be stressed. First, the price of crude oil has increased significantly in the 1970s and early 1980s. Slower world economic growth combined with a price-induced decrease in the quantity of oil demanded caused a softening of prices in 1981, which will continue in 1982.

Second, the aggregate OPEC and individual member's current-account balances have been dominated by oil price changes. Rising crude oil prices generate a current-account surplus which then tends to decline over time as the world economy adjusts to the higher price of oil. The outlook beyond the 1980 record surplus fits this pattern. Third, when put in perspective, the world's international money markets appear to be capable of recycling the declining OPEC surplus.

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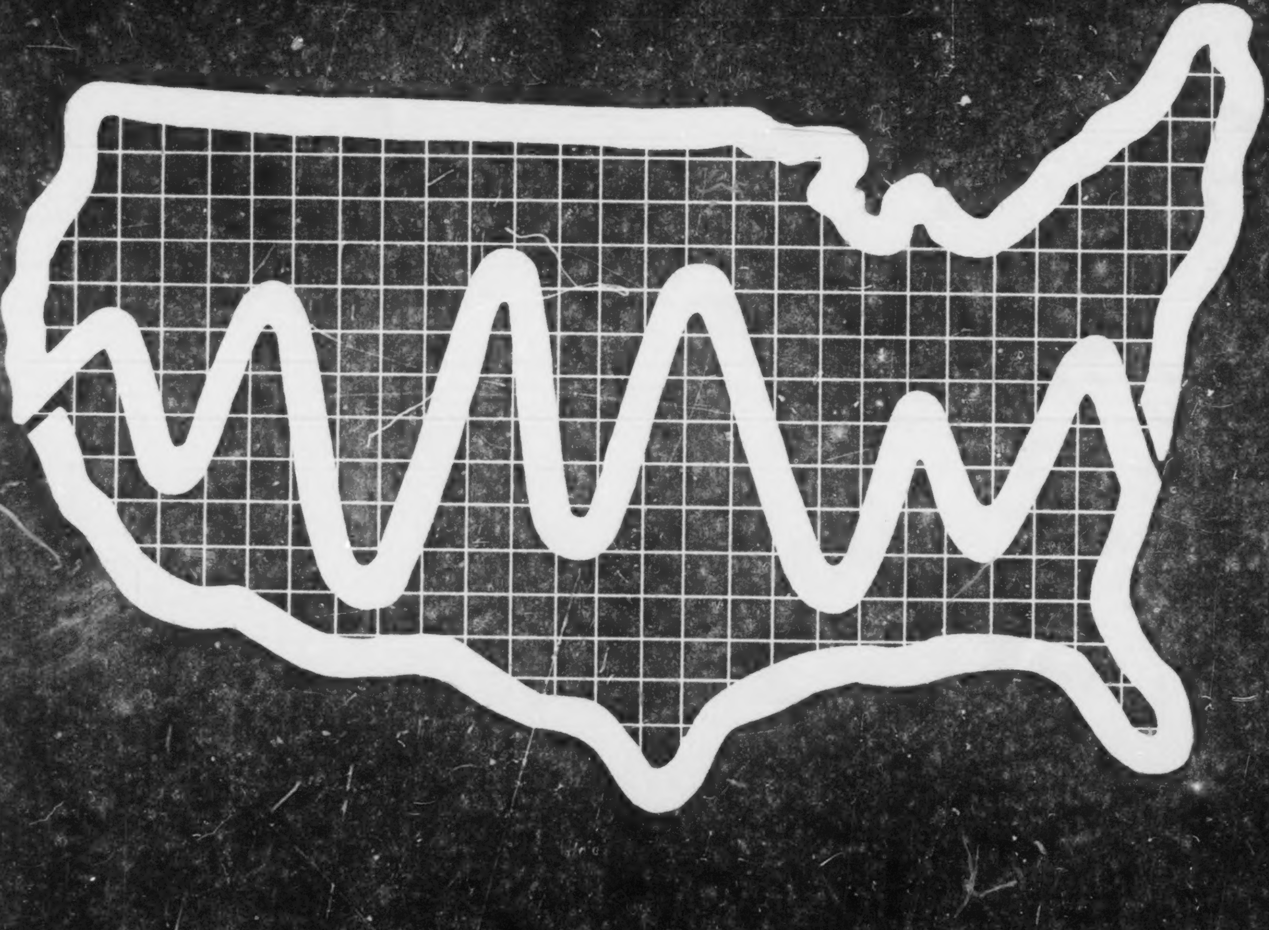

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Number 66

This report highlights the long-term outlook of the United States economy through 1987.

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SUMMARY

This report concludes that the United States economy will return to a more vigorous growth path during the next five years. By 1987, the total production of goods and services in the economy will have surpassed the $5 trillion level. Inflation, which is currently very moderate as a result of recessionary weakness in demand, is likely to return as the economy expands in the 1980s, although the rate of inflation is expected to be kept in check by a relatively tight monetary policy. Inflationary pressures should also be muted by the existence of a sizable gap between potential and actual output during the 1981-1987 period. Although the economy's trend growth rate from 1982 to 1987 is projected to be 3.2 percent, the current recession lowers that trend rate to only 2.5 percent for the 1981 to 1987 span.

The economy's potential output is projected to increase 2.7 percent per year from 1981 to 1987, or slightly more than the actual growth rate during that interval. Although productivity growth is expected to be approximately double the weak trend rate of just 0.7 percent that has hampered the U.S. economy since 1973, it will on average be only about half as great as the 3 percent average rate that has typified productivity growth in the U.S. economy over a very long period of time. Growth in the civilian labor force is likely to slow considerably from the robust increase of the 1970's and the declining trend in the length of the average work week is expected to continue.

Financial developments, which have been dominant in the performance of the U.S. economy during the last 2 years, are given an expanded role in this report. The overall projections of GNP and inflation are reconciled with the expansion in money supply and the growth in velocity of circulation in order to assure that the growth path for real output and prices is feasible in terms of the availability of money and credit. Trend rates of interest are projected for both short-term and long-term markets, and are reconciled with the major determinants of inflation and the forces shaping the supply and demand for money and credit during the next five years.

In addition to the detailed discussion of trends in financial markets, the report discusses issues and growth prospects in other key sectors of the economy including consumer spending, business investment and corporate profits, government spending and fiscal policy, the U.S. foreign sector, and inflation. A detailed inflation forecast is provided for the components of GNP. The report concludes with a discussion of trends in specific industries. Growth trends for detailed industry categories are ranked and summarized, based on the results of a detailed industry forecast using an interindustry forecasting model.

1982-1987: POLICY OVERVIEW

Traditionally, long-term economic projections have proceeded somewhat differently than short-term forecasts. The long-term focus tends to be on the economy's "supply side" or basic stock of physical and human resources, such as capital, labor, and productivity. Short-term studies typically tend to focus on "demand side" variables that are more cyclical and volatile, such as housing starts, auto sales, and retail spending. In the typical long-term study, the demand side is secondary, and financial variables generally do not play an important role.

The emphasis on supply-side variables in a long-term projection is logical since an economy's resource base tends to be more stable and predictable over a long period of time than does its demand side. Typically, there are several ways of proceeding to make long-term projections. One method commonly used is to specify goals or desired outcomes at some target date, say 5 years in the future. Such goals could consist of a balanced budget and full employment, for example. Given the targets, one then computes the growth path necessary to attain the desired end point. Such studies often demonstrate the difficulty of attaining the targets in just a few years' time. Another approach that has recently been popular makes projections based on the assumption that recent rates of resource use for key commodities such as oil, natural gas, or fresh water continue indefinitely. The end result is typically an economic disaster at some future date. To the extent that such studies do not allow for substitutes of increasingly scarce and higher-priced goods, they are very unrealistic.

The approach that is used in this study to obtain long-run economic projections has the goal of avoiding the pitfalls described above. The economy is projected to follow a 5-year growth path that is feasible both in terms of the resource base and the growth in aggregate demand over the 5-year horizon. Although no binding resource constraints, such as another oil shortage, are assumed in this set of projections, they would presumably not lead to a collapse of the economy, but rather to ultimately higher prices and conservation of the scarce commodity, as has been the result for petroleum. Special care has been taken to incorporate realistic assumptions about monetary and financial variables, which have been of central importance in economic events since 1979. If any resource is likely to restrain the growth of the U.S. economy during the next 5 years, it is likely to be the supply of credit.

The resolution of the current debate regarding the objectives of economic policy will be critical to the nation's economic performance during the next 5 years. Since 1979, the primary focus of economic policy has been on monetary and financial markets, and specifically on monetary policies designed to reduce the inflationary pressures that built up during the decade of the 1970's. Although inflation has decreased substantially in early 1982, there remains considerable uncertainty about the long-run prospects for control of inflation, and this concern is likely to result in the continuation of a policy of relatively slow expansion to the basic money supply, MI. Additionally, the slow economic growth since the beginning of 1980 has led to a federal government fiscal squeeze that has resulted in the current prospect of a series of very large budget deficits during the next several years.

The very high degree of public concern over large deficits and renewed inflation in the years ahead is likely to provide support for a continued cautious approach toward money growth. The basic economic projections in this report assume that the money supply, MI, will grow at a compound annual rate of 5.3 percent from 1982 to 1987. By comparison, the money supply grew at a compound annual rate of 6.5 percent from the end of 1973 to the end of 1981. The velocity of money, defined as the ratio of current-dollar GNP to the money supply, is projected to increase at a compound rate of 4.8 percent over the same period. This increase in velocity, while historically high, incorporates a period of cyclically high velocity growth as the economy recovers in 1982-1983, which raises the average somewhat. The combined growth of money and its velocity is equal to 10.4 percent per year, which, of course, is the same as the projected growth in current dollar GNP.

In summary, the economic projections contained in this report are based on a feasible growth path for the next 5 years which is integrated with our short-term outlook for 1982 and 1983, in order to take account of current realities such as high unemployment, tight credit, and large budget deficits. Our projections differ from some other long-term forecasts in assuming a rather strict monetary policy during the 1982-1987 interval. The money growth assumption limits the growth in current-dollar GNP, which is a product of real growth and the price level. The expansion in current-dollar GNP, in this framework, does not exceed the combined growth in the money supply, MI, and its velocity of circulation, a condition that must hold in the real world and yet is all too frequently overlooked in long-term projections. In this way, a discipline is imposed that should prevent unrealistically optimistic outcomes, since the forecaster must trade more real growth or higher prices for more money creation or a higher increase in velocity.

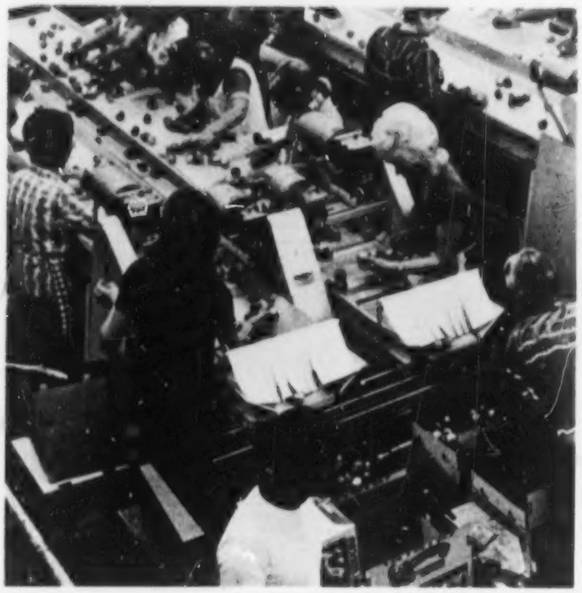
DETERMINANTS OF LONG-TERM GROWTH

DETERMINANTS OF LONG-TERM GROWTH

The economic policy debate in the last several years has been focused increasingly on the importance of "supply side" variables, such as business investment and the productivity of the work force. Although economic policy since late 1979 has mainly been concerned with inflation, and has probably even resulted in some short-term reduction in productivity growth and capital spending as a consequence of high interest rates, long-run concerns continue to be centered on the importance of fostering a return to vigorous economic growth, and hence, on the supply-side determinants of growth. The current dramatic reduction in inflation rates, although partly due to cyclical weakness in product demand that has resulted in reduced prices for many commodities, probably indicates that inflation is likely to become much less important as a focal point for public policy.

The U.S. Economic Potential

The economy is currently operating far below its long-run potential, resulting in historically high rates of unemployment and mushrooming federal budget deficits. The concept of "potential GNP", which measures what the output of the economy would be if all resources were fully employed, is useful in providing a measure of the gap between the economy's actual performance and its potential over time. Due to difficulties of measuring the capital stock, potential GNP is usually defined in terms of the full employment of labor. At a "full-employment" rate of unemployment, currently defined as about 5 percent of the labor force, the economy is assumed to be operating at its potential. In 1982, the gap between the economy's actual and potential output of goods and services is expected to average over 9 percent, which would be the largest gap since 1949, and is even higher than the 8.1 percent gap measured during the recession year of 1975. Indeed, the



last time when the economy performed at or above its potential was in 1973, when output was slightly above the full-employment potential level.

Growth in potential GNP averaged 3.3 percent from 1973 through 1981, although growth in actual output fell far short of that measure, increasing just 2.3 percent per year. The economic performance of the U.S. economy since 1973 compares very poorly with the long-run average annual growth rate of 3.5 percent realized since the end of World War II. It now appears that much of the poor economic performance since the full-employment year of 1973 may be attributed to the stop-and-go economic growth since the end of 1979. Although the recession of 1973-1975 was the worst thus far in the postwar period, much of that decline was due to a massive disruption in the supply and price of a specific key commodity, petroleum, from which the economy recovered much sooner and more strongly than expected. By early 1979, in fact, the economy was operating less than 2 percent below its potential output level, compared with a shortfall of over 9 percent at the trough of the recession in early 1975, and unemployment had returned to less than 6 percent by 1979 following a peak reading of 9 percent in mid-1975.

The Roots of the Current Malaise

Part of the explanation for the strong economic expansion of 1975-1979 lies in the relatively strong increase in the money supply that occurred during that period. The monetary aggregate of M-1, consisting mainly of cash and checking-type deposits, increased at a compound annual rate of 7 percent from the end of 1974 to the end of 1979, compared with the 4.6 percent growth rate of the prior 15 years from 1959 to 1974. That monetary growth, which was accompanied by a series of relatively large federal budgetary deficits, enabled a rapid expansion in consumer spending that contributed to renewed inflationary pressures that emerged in 1979 and 1980. A more restrictive monetary policy was begun in late 1979 which combined with heavy government financing needs stemming from the deficits of the 1970's to produce a very high level of interest rates that severely curtailed economic growth from early 1980 to the present. From the fourth quarter of 1979 through the end of 1981, real GNP increased only 0.5 percent, and our current short-term forecast for 1982 predicts a gain of only 0.6 percent from the fourth quarter of 1981 to the end of 1982, resulting in a compound annual growth rate of just 0.4 percent for the twelve quarters from the end of 1979 to the end of 1982. That poor performance, as we shall further explore in the following sections, will make it very difficult for the economy to return to a full employment level of output during the next five years.

FORECAST HIGHLIGHTS

1981-1987
(billions)

Aggregate Demand	**1973**	**1981**	**1987F**
Potential GNP (1972 $)	1248.8	1623.3	1901.0
Real GNP (1972 $)	1255.0	1510.0	1747.9
GNP Gap	–0.5%	7.0%	8.1%
Unemployment Rate	4.9%	7.6%	7.0%
Nominal GNP (current $)	1326.4	2924.8	5093.4
Growth Trends	**1973-81**	**1981-87**	**1982-87**
Real GNP	2.3%	2.5%	3.2%
Inflation	7.9%	7.0%	6.9%
Nominal GNP	10.4%	9.7%	10.4%
Hours per Worker	–0.6%	–0.5%	–0.5%
Productivity	0.7%	1.2%	1.4%
Labor Force	2.5%	1.7%	1.8%

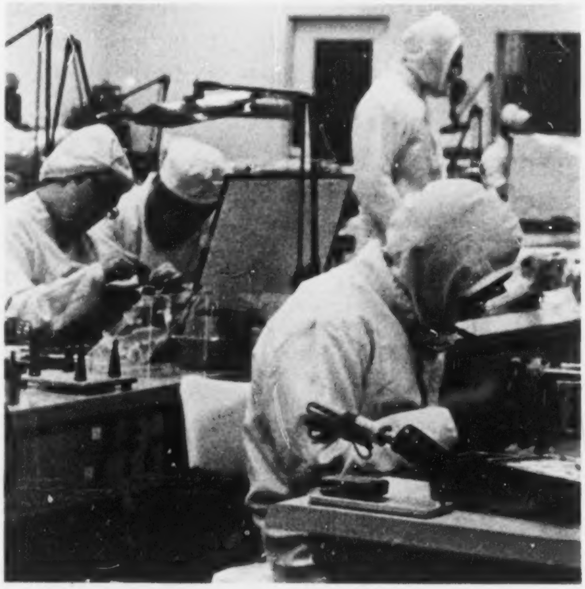
The Importance of Productivity

In contrasting the performance of the U.S. economy since 1973 to its record in the postwar period prior to 1973, one statistic stands out like a sore thumb: the abysmal weakness of productivity growth. Productivity in the private business sector of the economy, defined as real output (GNP) per hour worked, rose only 0.7 percent per year from 1973 to 1981, and has been virtually flat since 1977. Hence, gains in output since 1977 reflect mainly an increase in hours worked. From 1947 to 1973, the trend rate of productivity increase in the private business sector was 3 percent, or more than 4 times as great as during the last 8 years.

The causes of the recent sluggish productivity growth are many and complex. Among the more prominent reasons that have been advanced in an effort to explain the productivity decline, the relatively poor investment climate during the past 8 years probably leads the list. Business fixed investment increased only 2 percent per year in real terms during the 1973-1981 interval, or less than half the rate realized from 1947 to 1973. The disruption caused by the OPEC oil embargo in 1973, the high inflation trend of recent years, and the stifling effect of high interest rates have all served to discourage capital spending, which has impaired the modernization of plant and equipment in our economy. The weak trend in capital spending was accompanied by a surge in the labor force as record numbers of new workers entered the workforce in the mid-to-late 1970's, resulting in a reduction in capital per worker, which serves to lower productivity. Since new workers are generally less productive until they are fully trained, the large influx of trainees in the 1970's contributed to relatively low marginal productivity of labor. Environmental legislation during this period compounded the problem by causing an increased share of capital spending to be devoted to "non-productive" uses such as pollution control equipment. The federal government was deemphasizing basic research and development expenditures during the 1970's, as transfer payments accounted for an increased share of the budget. The effect of progressive income taxes in an inflationary environment operated to stimulate consumption and to hamper savings and investment. Finally, the structure of the entire economy was changing in a direction that tended to reduce productivity, as a higher share of resources went into the highly labor intensive trade and service sectors that are characterized by relatively low rates of average productivity. In summary, although the separate contribution of each of the factors cited above has proven difficult to identify, collectively they are thought to account for most of the decline in productivity growth since 1973.

THE PROSPECTS FOR ECONOMIC GROWTH

A simple extrapolation of trends of the recent past, combined with our current perspective from a point near the bottom of the second recession since the beginning of 1980, would lead to a fairly pessimistic economic outlook for the next five years. It is relatively easy, in the current context, to lose sight of the fact that the very high inflation and, especially, interest rates during the last few years constitute a very exceptional episode in our economic history, and that such excesses almost always lead to long-run corrections in a market economy. During the late 1970's and before, correction to high inflationary pressures was prevented from working by the continued monetization of large federal government budget deficits that enabled continued strong consumer spending for commodities at increasing prices and frequently on credit terms that could be viewed as very burdensome in a historical perspective. At the same time, the increased federal government presence in financial markets was, and is, leading to a reduced share for private-sector financing in the credit markets, and thus eroding the economy's ability to renew its capital stock sufficiently to promote the sort of economic growth — 3 percent or so — on which our societal expectations of living standards are based.



Inflation

Inflation, it now appears, is likely to be of less concern during the next five years than in the recent past, although it would be prudent to expect periodic episodes of price surges for specific goods or services even if the overall trend is seen to be moderating.

As measured by the GNP deflator, inflation averaged almost 8 percent annually from 1973 to 1981, compared with only 2.6 percent per year over the considerably longer period from 1947 to 1973. Although monthly and quarterly inflation rates have recently been closer to the historical reading above, it is likely that these low readings reflect primarily cyclical factors and that the longer-term, or "core" inflation rate will be closer to the average of the 1970's than to that of the earlier period. Our inflation projection for the next five years averages 7 percent at a compound annual rate, which is not a dramatic departure from the inflationary experience of the recent past, but would definitely represent a sharp break in the escalating trend of the last two decades.

LONG-TERM U.S. ECONOMIC OUTLOOK

1981-1987
(billions)

	Current $		1972 $	
	1981	**1987F**	**1981**	**1987F**
Gross National Product	2924.8	5093.4	1510.0	1747.9
Personal Consumption Expenditures	1857.9	3191.6	958.8	1114.4
Durable Goods	232.1	414.0	139.4	177.9
Autos and Parts	98.4	193.8	54.2	73.8
Except Autos and Parts	133.7	220.2	85.2	104.1
Nondurable Goods	743.0	1162.7	367.1	401.2
Services	882.7	1614.9	452.3	535.3
Gross Private Domestic Investment	450.6	887.2	215.0	277.3
Fixed Investment	433.7	848.2	207.4	264.8
Nonresidential	328.3	616.8	162.2	201.2
Producers' Durable Equipment	202.9	377.6	111.3	141.1
Structures	125.4	239.2	50.9	60.1
Residential	105.4	231.4	45.2	63.6
Change in Business Inventories	17.0	39.0	7.6	12.5
Government Purchases	591.2	997.1	291.8	311.4
Federal	230.3	422.3	111.6	124.4
Defense	154.4	334.3	74.0	96.4
Nondefense	75.9	88.0	37.6	28.0
State and Local	361.0	574.8	180.2	187.0
Net Exports	25.0	17.5	44.4	44.8

F = SPNB Forecast

Productivity Growth

The trend rate of growth in productivity is also expected to depart from the 1973-1981 experience during the next five years, with the exception of the recession-induced weakness in 1982. The trend rate of productivity growth in the private business sector is expected to average about 1.4 percent per year from 1982 to 1987, which is almost double the growth rate of the eight years following 1973, although still far below the long-term average rate of about 3 percent. Although part of this increase in productivity growth will represent a catch-up from the recessions of 1980 and 1981-1982, it will also reflect favorable long-term trends such as the increasing maturation of the labor force and a projected reversal of the decline in capital/labor ratios that occurred during the 1970's. The increase in productivity growth will be accompanied by a continuation of the trend toward a steady decrease in the length of the average work week. Average weekly hours worked by workers in the private business sector of the economy are projected to decrease from the 35.2 observed in 1981 to about 34.1 in 1987. This rate of decline in hours worked is slightly less than the 0.6 percent average annual decline observed in the U.S. economy from 1973 to 1981.

Labor Force

In constrast to the weak growth in productivity and the decline in the average work week since 1973, the civilian labor force increased quite rapidly during the last 8 years. Revised estimates of labor force growth during the 1970's, based on the results of the recently completed 1980 Census of Population, show that the civilian labor force grew at a compound annual rate of about 2.5 percent from 1973 to 1981, compared with only 1.6 percent from 1947 to 1973. The growth surge of the 1970's largely reflects the maturation of the post-World War II "baby boom" generation, and is likely to be followed by a rate of growth more in line with longer-term experience.

Certain difficulties are posed by the current state of official labor force estimates. The recently completed 1980 Census resulted in revised estimates that increased the 1980 labor force by about 2 million persons in total. As yet there exists no official projection series that is based on the revised estimates, which show much faster growth for the 1970s than previously had been estimated. Accordingly, the labor force projections for 1981-1987 contained in this report, including participation rates of men and women, are based on our own analysis of current population trends. We are projecting that the civilian labor force will increase at a compound annual rate of 1.7 percent from 1981 to 1987. Considering that the labor force is growing very slowly during the current recession, the 1982-1987 growth rate of 1.8 percent per year is likely to be a more representative trend.

The labor force participation rate, defined as the percentage of the civilian noninstitutional population aged 16 years and over that is either working or looking for work, is projected to increase from an estimated 63.9 percent of the relevant population in 1981 to 67.1 percent in 1987. The participation rate among males, which has recently been declining slightly, is expected to edge up gradually from the 77 percent estimated for 1981 to 77.5 percent in 1987. Although the trend toward increased participation by workers aged 65 and over may have a positive effect on labor force participation of both men and women, it is probably offset by a trend toward earlier retirement from the primary career. Clearly, labor force participation among men appears to be nearing a maximun. Participation rates for women have grown steadily and dramatically during recent years, from 43.3 percent in 1970 to an estimated 52.1 percent in 1981. The participation rate for females is expected to continue to increase during the next five years, reaching 57.7 percent in 1987, although the rate of increase is expected to slow.

The Outlook for Real Growth

The combined growth of labor force, productivity, and hours worked per employee determine how rapidly the economy can grow over time. This is another way of looking at the concept of potential output discussed earlier in this report. Potential GNP is expected to grow at a compound annual rate of 2.7 percent from 1981 to 1987, compared with a 3.3 percent growth rate from 1973 to 1981. The slowdown in the growth of potential GNP in the 1980's is due to the more moderate expansion of the labor force, since productivity is expected to be growing faster than during the 1970s.

Actual GNP is projected to grow by about 3.2 percent per year, somewhat faster than the growth in economic potential between 1982 and 1987. It becomes possible for the economy's actual growth rate to outdistance the growth of potential because at the starting point for this comparison, in 1982, the economy will be operating about 10 percent, or close to $150 billion in 1972 dollars, below its potential growth path. Just how damaging the current recession has been to the economy's long-run growth prospects may be seen by including 1981 in the period of comparison. The inclusion of this one additional year lowers the trend rate of growth to 1987 from 3.2 percent to just 2.5 percent, which is slightly above the 2.3 percent average real growth rate from 1973 to 1981. This lowering of the projected growth rate takes place because real GNP is declining, on average, from 1981 to 1982.

As a result of the inflation and real growth trends, current dollar GNP is expected to increase at a compound annual rate of 10.4 percent from 1982 to 1987, or 9.7 percent from 1981 to 1987. Total GNP in current dollars should reach almost $5.1 trillion based on these trend rates of growth. The fastest growing components of real GNP, not surprisingly, are generally those that have been somewhat depressed during the last two years, such as consumer durable goods, especially autos and parts; residential investment; and producers' durable equipment. In the public sector of the economy, federal government purchases of defense goods are expected to increase 4.5 percent per year in real terms. A declining share of output will be taken by consumer spending for nondurable goods, and by state and local government expenditures. The overall share of consumption spending in real GNP is likely to be about the same in 1987, at 63.8 percent, as it was in 1981. The share of real GNP going to business fixed investment should increase significantly from the depressed base of 1981. The government's share of output is expected to fall from 19.3 percent in 1981 to 17.8 percent in 1987, reflecting the declines in federal nondefense spending and state and local government spending.

GNP GROWTH AND SECTORAL SHARES

	1981-1987 Growth Trend (Current $)	1981-1987 Growth Trend (1972 $)	Share of GNP (Current $) 1981	Share of GNP (Current $) 1987F	Share of GNP (1972 $) 1981	Share of GNP (1972 $) 1987F
Gross National Product	9.7	2.5	100.0	100.0	100.0	100.0
Personal Consumption Expenditures	9.4	2.5	63.5	62.7	63.5	63.8
Durable Goods	10.1	4.1	7.9	8.1	9.2	10.2
Autos and Parts	12.0	4.7	3.4	3.8	3.6	4.1
Except Autos and Parts	8.7	3.8	4.6	4.3	5.6	6.1
Nondurable Goods	7.7	1.5	25.4	22.8	24.3	23.0
Services	10.6	2.8	30.2	31.7	30.0	30.6
Gross Private Domestic Investment	12.0	4.3	15.4	17.4	14.2	15.9
Fixed Investment	11.8	4.2	14.8	16.7	13.7	15.1
Nonresidential	11.1	3.7	11.2	12.1	10.7	11.5
Producers' Durable Equipment	10.9	4.0	6.9	7.4	7.4	8.1
Structures	11.4	2.8	4.3	4.7	3.4	3.4
Residential	14.0	5.9	3.6	4.5	3.0	3.6
Change in Business Inventories	—	—	0.6	0.8	0.5	0.7
Government Purchases	9.1	1.1	20.2	19.6	19.3	17.8
Federal	10.6	1.8	7.9	8.3	7.4	7.1
Defense	13.7	4.5	5.3	6.6	4.9	5.5
Nondefense	2.5	–4.8	2.6	1.7	2.5	1.6
State and Local	8.1	0.6	12.3	11.3	11.9	10.7
Net Exports	–5.8	0.1	0.9	0.3	2.9	2.6

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THE UNITED STATES ECONOMY THROUGH 1987

THE FINANCIAL ENVIRONMENT

The economy and financial markets in the coming years will be dramatically colored by several key factors: the new fiscal policies of the Reagan Administration, continued monetary restraint on the part of the Federal Reserve, deregulation of the financial industry, further innovations in the payments mechanism, and, it is presumed, by a gradual disinflation process. More than at any time in decades, the combination of new stabilization policies, financial deregulation, and the effects of more conservative politics will change the patterns of U.S. economic growth, saving, inflation, and interest rates.

The sweeping tax rate cuts enacted in 1981 make the prospect of persistent and large budget deficits likely through much of the next five years. Since inflation expectations are importantly influenced by government deficits, it will be critical that the Federal Reserve maintain tight control of monetary growth, even at the risk of a sluggish economy. Having focused financial market attention on the money supply, the Federal Reserve will be forced to keep money growth close to its long-term targets — a policy course which will maintain interest rate volatility and promote continued discomfort for the Federal Reserve.

Another important issue for the period ahead is the financial position of business corporations. The sharp increase in the use of short-term debt in the late 1970s and early 1980s leaves businesses at a postwar peak for the ratio of short-term to total liabilities. In order to improve their debt structure, businesses will require substantial sums of long-term financing over the period ahead. These swollen credit demands, coupled with sizable mortgage credit needs and the Treasury's hefty appetite for funds, will maintain pressure in credit markets.

It is clear that interest rates have been much more volatile since the Federal Reserve changed its operating procedures in October 1979 to focus more on money supply growth. Close attention to these targets will promote persistent gyration of interest rates over economic cycles as the Federal Reserve attempts to ratchet down both interest rates and inflation in the years ahead. Interest rates will fluctuate at high levels by historical standards, due importantly to three factors. First, in a deregulated environment the price of credit, rather than its availability, will be the primary rationing device. Thus, rates must go higher than in the past to discourage borrowing. Second, the volume of borrowing is importantly determined by real after-tax borrowing costs. But with full tax deductibility of interest expenses and with interest income being taxable, the real interest rate associated with a given real after-tax borrowing cost rises with inflation. Therefore, the higher inflation is, the higher interest rates must be in order for real after-tax borrowing costs to restrain borrowing. Third, investors must be compensated for the greater volatility of bond returns since 1979, a factor which should raise real bond rates in the future compared with the 1960s and 1970s.

As shown in the interest rate chart, over the next several years both long-term and short-term rates are expected to average higher than during the past five years but substantially below current levels. Given our inflation assumption of 7 percent, even with the rate declines forecast, real interest rates (measured simply by subtracting concurrent inflation rates) would appear to remain very high. A distinction must be made on this point, however, between short-term and long-term interest rates. For short-term rates it is certainly true that our forecast calls for very high rates relative to recent history. Such an occurrence is not surprising in a disinflation period, however. In such times, investors are slow to believe that disinflation is permanent and they act accordingly: they demand a higher real return to hedge against an anticipated resurgence of inflation. By 1984 most of this imbalance should be corrected, and real short-term rates ought to move closer to their long-term "normal" of 2 to 2.5 percent.

INTEREST RATE OUTLOOK
1982-1987

	5-Year Average 1977-81	1981	SPNB Forecast (1982-87) Average
Short-Term:			
Prime Rate	12.54	18.87	13.00
Commercial Paper — 90-day dealer	10.49	15.33	10.50
Treasury Bills — 3 month	9.60	14.03	9.50
Treasury Bills — 1 year	9.45	13.14	9.75
Federal Funds	10.88	16.38	10.75
Certificates of Deposit — 3 months	10.81	15.92	11.00
Longer-Term:			
3-Year U.S Governments	10.14	14.44	11.00
Aaa Corporate Bonds	10.50	14.17	12.00
New Aa Utilities	11.41	16.25	13.00
Mortgage, Conventional—Commitment	12.13	16.71	14.00

With regard to long-term rates, it is not as clear that our forecast calls for high real rates since real bond rates ought to be equal to the nominal rate minus the expected inflation rate over the remaining life of the bond. In other words, bond investors must implicitly assess not only current but future inflation prospects when making a decision on a bond. And, given the current prospects for large government deficits for years to come, investors' assumptions about future inflation may remain negative for some time — keeping nominal long-term rates high and perceived real long-term rates within historical experience.

Over the next five years, after-tax returns to saving and after-tax borrowing costs should be higher than during the late 1970s. An important fallout of this change will be a shift toward more saving and investment, as well as the resumption of a better balance between financial vs. tangible investment.

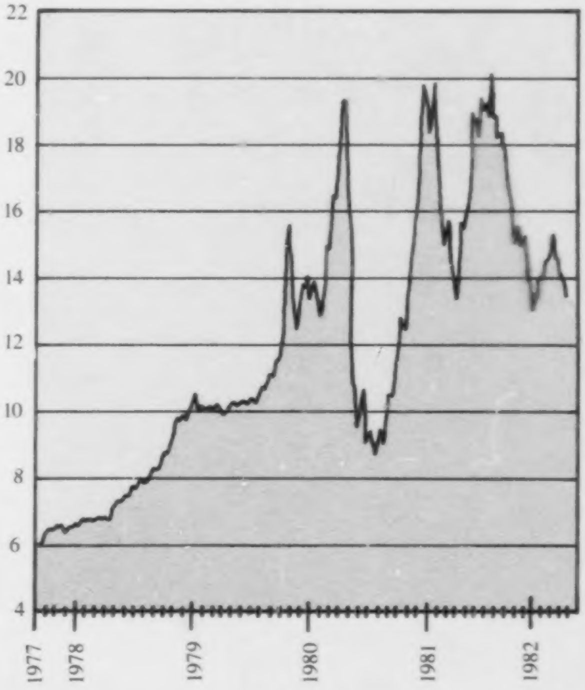
Turmoil will remain a key word in describing the adjustment process of depository institutions to a less regulated environment. Thrift institutions in particular will continue the consolidation process currently underway due to their concentration in mortgage lending. A new financial services industry is emerging — one which is more efficient and more diversified in terms of its lending and funding activities.

In the 1970s, electronic technology began to dramatically change the U.S. financial structure. This information revolution will accelerate in the years ahead, facilitating a more broadly-based portfolio for households and businesses and a reduced need for money as traditionally defined. The current debate about what should be included in the official definition of money — the aggregate to be closely controlled by the Federal Reserve — will intensify. The velocity of traditionally-defined money will rise sharply, with the same amount of "money" supporting ever more economic activity.

The velocity gain, however, will not likely be sufficient to remove the substantial pressures on the Federal Reserve. The end result may well be another shift in Federal Reserve operating procedures, such as increasing the emphasis on broader measures of money or using real interest rates as targets. At the very least the Federal Reserve may be forced to accept a stabilization of money growth rates rather than the continued reductions now planned for future years.

In sum, the next few years will witness important changes and will determine whether the U.S. economy can withstand the discomfort that must come with disinflation and financial deregulation. The period ahead is a critical one. If it is filled with external shocks, such as occurred during the 1970s, or if the experiment of the New Federal Reserve policy fails, the pattern of behavior in the U.S. economy and financial markets will likely be one of continuing instability and the costs of such instability would be substantial. If the U.S. economy avoids major shocks and the Federal Reserve is able to withstand the pressure to a large extent — the assumptions underlying this forecast — the period ahead, though challenging, will provide the base for a much healthier economy in the late 1980s.

COMMERCIAL PAPER RATE:
BEFORE AND AFTER THE NEW FED POLICY
(PERCENT)



THE OUTLOOK FOR INFLATION

Since the second half of the 1960s the trend of inflation in the United States has become increasingly troublesome. While the foundation of the inflation of the 1970s had been laid in part during the previous decade by such influences as the financing of the Viet Nam conflict concurrently with major social reforms and an ambitious space program, it took a shock of great magnitude like the oil crisis and its effect on prices to bring the inflation problem clearly into focus. During the past decade concepts such as the "underlying rate of inflation" or "core" inflation not only became popular topics of discussion, but the once esoteric jargon of price watchers suddenly seemed to become commonplace. It is very worthwhile to review some of the more significant causes of high rates of inflation of the past several years in order to assess what might be different in the future.

Where does Inflation Come from?

The persistence and stubborness of U.S. inflation is underscored by the fact that despite the major recession of 1974-75 and the deep but short 1980 recession, 1980's underlying inflation rate was around 9%, and consumer prices in that year jumped ahead of the previous year's level by 13.5%. The reasons for the abominable inflation performance of the 1973-81 period are largely known and the list includes:

- Actual wage gains averaging in the neighborhood of 8% annually during the period;
- Disastrous productivity growth resulting from a stagnation of the capital stock and the burden of energy costs;
- Periodic weakening of the trade-weighted dollar exchange rate which brought additional price pressures on imported goods;
- Food price surges in 1974 and 1978-79;
- Tax policies that did little or nothing to lower capital costs or to stimulate saving and investment;
- A temporary consumer price improvement during 1976-1977 that misled policymakers and weakened their resolve to combat inflation;
- President Carter's price and pay policy of 1978 that again did little more than gloss over the deep seated inflationary roots and set the stage for subsequent price-and-pay leapfrogs;
- And, stop-go monetary policy that was too easy (on average); that allowed dramatic swings in interest rates; that validated huge fiscal deficits throughout the period; and that seemed to overcorrect for swings in the monetary aggregates.

If it had not been for the 1980 recession, the U.S. would very possibly have entered this decade with an underlying inflation rate at double-digit levels. Indeed, in 1980, wages were accelerating at an annual rate of 8.9%, while productivity increased at only 0.8%. At the same time, energy prices were climbing substantially, causing further inflation shocks.

INFLATION OUTLOOK
GNP COMPONENT DEFLATORS
1981-1987

	1973-81	1981-87
Gross National Product	7.9	7.0
Personal Consumption Expenditures	7.9	6.7
Durable Goods	6.4	5.7
Autos and Parts	7.6	6.3
Except Autos and Parts	5.5	5.1
Nondurable Goods	8.1	6.2
Services	8.1	7.5
Gross Private Domestic Investment	--	—
Fixed Investment	8.9	7.4
Nonresidential	8.7	7.2
Producers' Durable Equipment	7.6	6.6
Structures	10.9	8.3
Residential	10.0	7.7
Change in Business Inventories	—	—
Government Purchases	8.3	7.9
Federal	8.6	8.6
Defense	8.7	8.8
Nondefense	8.4	7.7
State and Local	8.2	7.4
Exports	9.3	7.4
Imports	12.4	6.9

F = SPNB Forecast

Has the Inflation Battle been Won?

A familiar yet still true statement is that since it took some twenty years for inflation to get so out-of-hand, it will also take some years to reduce inflation significantly. While that may be the case, at least there is already some evidence that inflationary forces in the U.S. economy are cooling. Of course, the present recessionary environment is a major promoter of that cooling trend. For the longer term the likelihood of a slowdown in the rate of price increases also appears to be rising. There are a number of subtle yet important changes that are now occurring within the U.S. economy that should have a prolonged downward effect on the level of price increases. As a result, the expected trend growth in the GNP deflator for the 1981-87 period is 7.0%. By comparison, for the period 1973-81 the GNP deflator grew at a trend rate of 7.9%.

One of the more meaningful events of the coming years will be the return to positive growth in productivity. While this trend has been discussed elsewhere in this Economic Report, it bears mentioning again since growth in productivity is essential to a sustained containment of inflation. In a related context, many inflation watchdogs have pointed to the "give-backs" and "give-ups" of contract wage increases and employee benefits in troubled-industry labor negotiations as perhaps being the harbinger of increased labor flexibility. The question of course is, will those who have lost salaries and benefits through give-backs simply inflate their contract demands when their firm or industry is on a sounder footing? There does seem to be some evidence that a declining inflation trend would temper future contract demands, but it is not certain whether there will be a recouping period first.

A second area of improving price trends for consumers will be energy, particularly prices for petroleum products. Unlike the oil price shocks of the 1970s, the outlook for the next several years of this decade is one of sufficient petroleum supplies and price increases that average less than 10% per year. That view, of course, does assume political stability worldwide sufficient to prevent another oil crisis. Since oil is a key ingredient in such a large number of other products, a period of relatively small oil price increases could have a substantial impact on lessening price increases for many products, thus helping to hold the line on prices in general.

A third component on any successful campaign against inflation is said to be the pursuit of non-inflationary monetary policy by the Federal Reserve. In this Economic Report the assumption is made that the Fed will maintain a relatively restrictive posture that will not validate fully the sizable federal budget deficits that are likely in the years immediately ahead. As a result of the Fed's reluctance to allow rapid growth in the nations money supply, interest rates will be held at relatively higher levels than would be allowed under an accommodative stance. And, since interest rates will not be falling precipitously, it is expected that the moderate expansion of the economy consistent with relatively high interest rates will help to avoid re-igniting inflation due to extensive demand pressures.

CONSUMER SPENDING

The outlook for consumer spending to 1987 is conditioned very much by the starting point for this projection, which falls in a period characterized not only by high unemployment rates and tight credit, but also by a considerable backlog of demand based on postponement of durable goods purchases. Consumer spending for durable goods, in fact, was lower in real terms during the first quarter of 1982 than it was in late 1977, more than four years ago. Demand for furniture and appliances has also weakened along with the slumping housing market. There is not much question at this point about the existence of a large pent-up demand for durable goods. The release of this postponed spending during the next year or two should, by itself, elevate consumer spending to a fairly high average growth rate during the next five years.

The major question for consumer spending, especially for motor vehicles, concerns the equilibrium level of stocks of durable goods. There is some reason to believe that, once the current backlog of demand for autos has been worked off, the equilibrium demand for cars will be lower in relation to population than during the recent past. The auto stock in this nation has been aging gradually during the last several years, and currently averages about 6.5 years old. Although that average age should drop as postponed replacement occurs, it may indicate that the recent weakness of auto sales is not due entirely to cyclical factors such as high unemployment and weak income growth, or to tight credit.

In the opinion of some auto industry observers, there appears to have been a downward shift in long-term demand for autos that has occurred in response to higher operating costs, higher prices (relative to other goods and services), disappointment over product quality and performance, and, even more intangible, perhaps the end of the traditional American love affair with the family car(s). Although these "taste" factors are difficult to identify, the net effect of the shift in demand for autos would be to lower the equilibrium demand for autos during a reasonably good year in the 1980s to perhaps 10 million units, compared with a good year of 11 million units during the 1970s. Considering that population will have increased more than 10 percent from 1978, the last year when 11 million cars were sold, to 1987, when we are also projecting a demand for 11 million units, this represents a major shift in demand. Thus, real consumer spending for durable goods is expected to increase much faster than real GNP over the next 5 years, but much of that growth will represent a catch-up.

Consumer expenditures on nondurable goods are expected to lag other categories of consumer spending between 1982 and 1987. The steep price increases for gasoline and other petroleum derivatives during the 1970s and beyond have resulted in a substantial decrease in real spending for gasoline and fuel oil, and that declining trend is projected to continue through most of the 1980s, as recent price reductions for gasoline and other fuels are expected to be only temporary, and largely the result of recession. Real spending on food and beverages is also likely to be rather weak during the 1980s, although production of food for export is expected to be a good growth area. Consumer spending for clothing and shoes is likely to be the strongest component of nondurable goods during the next 5 years. Consumer spending for services, including housing, household operation, and transportation, should be growing somewhat faster than the trend rate of GNP growth, as the long-run trend toward increasing concentration of economic activity in the service sector is expected to continue.

Real Real
Sale Sale
1/2 off 1/2

BUSINESS INVESTMENT AND CORPORATE PROFITS

From 1973 to 1981, nonresidential fixed investment increased at a compound annual rate of 10.9 percent. As a result, capital spending as a share of nominal GNP, continued on the secular upward trend of the past twenty years. By 1981, this ratio had risen from 10.8 percent in 1973 to 12.1 percent. Over the period, the compound annual growth in outlays for structures of 12.2 percent exceeded the 10.4 percent annual growth in outlays for durable equipment.

Adjusting these nominal growth rates for the effects of differing rates of inflation, however, alters the foregoing conclusions significantly. In real terms, capital spending declined as a share of real output from 11.0 percent in 1973 to 10.7 percent in 1981. Furthermore, because a rising share of capital formation was devoted to adjustments to cope with higher energy prices and to complying with both environmental and safety regulations, a decreasing proportion of total real investment became available to produce goods and services.

This overall decline in the share of real output allocated to productive capital reflected the effects of several factors that combined to discourage investment. Furthermore, the decline had a significant impact on the overall performance of the U.S. economy, including a slowing in the increase of labor productivity. (This particular impact is discussed elsewhere in this report.) As already mentioned, the period since 1973, was one of increasing concern for environmental conditions and on-the-job safety of workers, which translated into additional regulatory legislation at both the state and federal levels. Compliance with environmental regulations alone resulted in a rise of pollution abatement expenditures from some 1.5 percent of total nonfarm plant and equipment outlays in the late 1960's and early 1970's, to 3.5 percent during the late 1970's. Secondly, the increase in the rate of inflation over the period was a major contributing factor to a general increase in the perceived riskiness of investment. This increased risk not only contributed to the reduced share of real output allocated to investment but also resulted in a greater share of investment accounted for by shorter-lived assets. For example, investment in structures declined from 34 percent of real non-residential fixed investment in 1973 to 31 percent in 1981.

The relatively modest rate of increase in real output projected through 1987 will not provide a particularly rapid rise in the expected return to capital and ultimately fixed investment; however, other factors should provide additional incentive for capital formation. Although environmental and safety requirements may not decline in the period, the pace of further regulation should slow. Secondly, a slowing in the expected rate of inflation should contribute further to a more stable economic environment, conducive to an increased rate of investment.

Through 1987, real nonresidential fixed investment is expected to grow at a compound annual rate of 3.7 percent, compared with the 2.0 percent growth rate of the historical period. By 1987, capital spending is expected to account for 11.5 percent of real GNP. Investment in both equipment and structures is projected to increase more rapidly in the period ahead. Investment in structures, however, will continue to represent a declining share of total capital spending.

An additional factor encouraging increased capital formation is an expected rise in corporate operating profits (i.e., before tax profits with inventory valuation adjustment and capital consumption adjustment) relative to GNP. From 1973 through 1981, corporate operating profits rose at a 7.4 percent compound annual rate and fell from 8.2 percent of GNP to 6.6 percent. The more rapid increases in before after-tax profits were largely attributable to an increase in the tax-based depreciation expense, which did not keep pace with the

CORPORATE PROFITS OUTLOOK
1981-1987

	(Current $ — Billions)		Growth Trend	
	1981A	1987F	1873-81	1981-87
Corporate profits w/IVA & CCA (operating profits)	191.7	349.4	7.4%	10.5%
Corporate profits before taxes	233.3	375.4	8.0%	8.3%
Corporate profits after taxes	155.5	250.6	9.3%	8.3%
Capital consumption allowance	183.8	377.2	12.1%	12.7%
Total: CPAT and CCA	339.3	627.8	10.7%	10.8%
Dividends	63.1	94.0	11.2%	6.9%
Cash flow less dividends	276.2	533.8	10.6%	11.6%
Retained earnings	94.4	156.6	8.1%	9.2%
Capital consumption adjustment	–13.9	+20.0		
Inventory valuation adjustment	–27.7	–46.0		
Effective tax rate	33.3%	33.2%		
Dividend payout ratio	40.6%	37.5%		
Operating profits/GNP	6.6%	6.9%		
CPAT/GNP	5.3%	4.9%		

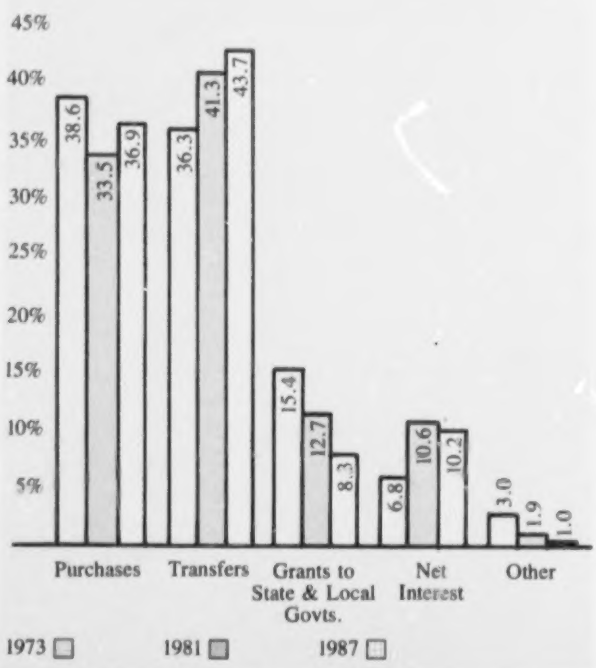
economic deterioration of the capital stock, the reduction in the statutory corporate tax rate, and the increase in the effective investment tax credit rate.

During the period ahead, operating profits are projected to rise at a compound annual rate of 10.5 percent. The projected slower growth in before tax profits reflects the impact of the Economic Recovery Tax Act of 1981. In particular, the accelerated Cost Recovery System will permit more rapid write-off of business investment. Although one effect of this faster write-off is to reduce before tax profits, the internal cash flow is improved. In addition, the dividend payout ratio is projected to decline as a greater share of internal cash flow is allocated to capital spending.

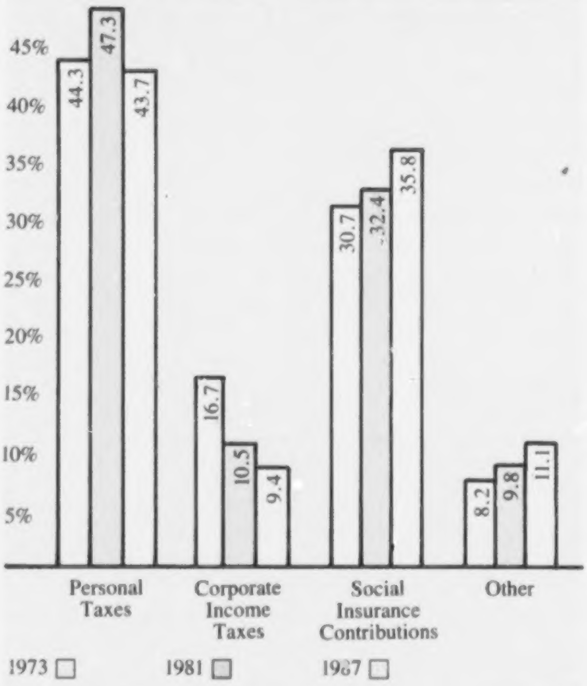
GOVERNMENT SPENDING

From 1973 through 1981, the interaction of both political and economic factors resulted in an increase in the role of the federal government in the economy. Budget receipts, outlays, and the deficit all increased relative to GNP. In addition, the composition of both receipts and expenditures altered significantly over the period. Through 1987, a reversal of some of these trends is expected to be observed. By 1987, federal outlays, receipts, and the budget deficit are projected to fall relative to GNP although each would represent a larger share of GNP than the respective 1973 proportions.

COMPOSITION OF FEDERAL BUDGET OUTLAYS
NIA BASES, CALENDAR YEARS



COMPOSITION OF FEDERAL BUDGET RECEIPTS
NIA BASES, CALENDAR YEARS



On the National Income Account basis, federal government revenues increased at a compound annual rate of 11.7 percent from 1973 through 1981. As a proportion of GNP, federal receipts rose from 19.5 percent in 1973 to 21.4 percent in 1981. This increase in federal receipts reflected both the effects of real growth over the period and of an accelerating rate of inflation. In particular, a 10.0 percent annual increase in the personal income tax base combined with a progressive tax rate structure to raise the effective tax rate from 12.1 percent in 1973 to 14.6 percent by 1981. As a result, personal tax receipts rose at a 12.6 percent annual rate. In addition, personal tax receipts rose from 44.3 percent of total receipts in 1973 to 47.3 percent in 1981. Federal outlays rose at a 12.7 percent annual rate over the historical period. In 1973, federal budget outlays represented 19.9 percent of GNP. By 1981, this proportion had reached 23.5 percent. Approximately a third of this increase was attributable to an increase in federal purchases of goods and services. In fact, in terms of constant dollars, federal purchases relative to GNP declined over the period from 7.6 percent to 7.4 percent.

This decline was largely attributable to a reduced share of real GNP allocated to military-related expenditures. In constant dollars, military expenditures rose at a compound annual rate of 1.0 percent. The increase in the federal government's outlays as a proportion of GNP was largely attributable to increased transfer and net interest payments. Federal transfer payments rose from 7.2 percent of GNP in 1973 to 9.7 percent in 1981, while net interest payments rose from 1.4 percent of GNP to 2.5 percent of GNP.

For the period ahead, the growth in federal government receipts is projected to slow to a 9.3 percent annual rate. This slowing in the growth rate can be attributable to two factors: the expected slower rate of inflation and the scheduled tax rate reductions of the Economic Recovery Tax Act of 1981. Thus, federal receipts are expected to decline to 20.9 percent of GNP by 1987. These factors will also result in a change in the composition of federal revenues. Personal tax and nontax payments and corporate income tax liabilities will both decline relative to GNP and as a share of budget receipts. In contrast, indirect taxes and contributions for social insurance are projected to rise relative to GNP and as a share of federal receipts.

Although federal budget outlays are projected to increase at an 8.8 percent annual rate from 1981 through 1987, outlays relative to GNP should fall to 22.5 percent by 1987. Over the period, federal purchases are expected to increase both as a share of budget outlays and as a share of GNP. This increase is largely attributable to projected increased military purchases. Defense outlays in constant dollars are projected to increase at a compound annual rate of 4.5 percent, and in current dollars, at a 13.7 percent rate. Although this rate of increase is lower than the 17.6 percent annual rate of increase incorporated in the Administration's 1983 Fiscal Year Budget, military spending would rise as a share of GNP in terms of both current and constant dollars. Although federal transfer payments will continue to rise relative to total budget outlays, their share of GNP will remain essentially unchanged. Grants to state and local governments are expected to continue to decline relative to both total outlays and to GNP. In 1973, the federal budget deficit (NIA basis) was $5.6 billion. By 1981, the deficit had risen to $62.7 billion. The deficit is projected to rise significantly in the near term and to remain at historically high levels throughout the remainder of the forecast period. By 1987, the budget deficit is expected to be approximately $80 billion. This deficit level would be equal to 1.7 percent of GNP.

State and local government spending will continue to reflect the effect of increased fiscal pressures through 1987. As noted previously, federal government transfers to state and local governments are expected to decline relative to total budget outlays and to GNP. State and local government purchases of goods and services are projected to increase at an 8.1 percent annual rate from 1981 through 1987, in contrast to the 12.1 percent annual rate of growth since 1973. After adjusting for inflation, state and local government purchases are expected to rise at an 0.6 percent annual rate.

THE FOREIGN SECTOR

Trends in the external sector of the U.S. economy are expected to be relatively undramatic over the forecast period. The surplus on net exports will narrow somewhat in 1982, recover modestly in 1983, but remain below the 1981 mark of $44.9 billion. By 1987 the net exports surplus will have widened to about $86 billion.

Numerous cross-currents will be at work, each one mitigating some of the impact of others. For example, a pick-up in the rate of real economic growth over the period suggests greater import "pull," but continued improvement in the oil bill will be somewhat offsetting. That improvement, in turn, is based on the expectation that the real price of oil will remain flat through 1987, together with the probability of further advances in the rationalization of energy use.

Exports are anticipated to be bolstered by a recovery of economic growth among major U.S. trading partners. Nevertheless, economic growth rates worldwide will not be as robust as in the past. Additionally, as will be discussed, the dollar is expected to remain basically strong versus the currencies of trading partners, suggesting little in the way of an exchange-rate related price differential. Export volume, i.e., the real export number for 1983, is, therefore, forecast to be only slightly higher in 1984 than in 1981, although it will be significantly higher than the 1982 number.

The assumption concerning the strength of the dollar is based on the more solid performance of the U.S. economy and a rate of inflation that will be declining. The U.S. fiscal position improves over the period, particularly in terms of the GNP percentage represented by the deficit. These trends suggest, as indicated, a decline in interest rates — although not a precipitous one — and when combined with the expectation that rates may be declining more rapidly in other countries, will also support a strong dollar. Political factors also favor the dollar. As an example, in the Middle East, anything short of a blowup would be interpreted as adding to the dollar's strength.

In total, therefore, the long-term outlook for the U.S. dollar does not show the extreme movements of the past. The dollar enters the forecast period in a more assured position. Some erosion of that strength may be seen gradually; however, no precipitous fall is forecast. Hence, the currency factor is not anticipated to contribute to strong present variations in the net export number.

The international monetary system is seen as remaining basically in place over the period, continuing to function through the flexible, hybrid rules governing currency defense mechanisms. Alternatives to the present system, such as replacing the dollar's key roles with the use of Special Drawing Rights, the return to a gold standard, or completely flexible exchange rates, all have major political drawbacks. Additionally, alternative key currencies, such as the European Monetary Unit, are not likely to emerge. Hence, the international financial setting over the forecast period does not appear loaded with the mine-fields of the past.

UNITED STATES INDUSTRY OUTLOOK

A PEEK AT COMPARATIVE GROWTH RATES

A comparison of product shipments over the 1982-87 time period provides an opportunity to rank several key industries in terms of their relative growth prospects. In the following table, thirty key industries have been arrayed according to three growth categories: faster, moderate, and slower. The annual trend growth rates for the thirty industries comprising the representative list show a reasonably consistent pattern when compared with anticipated GNP sectoral share trends for the same period.

The Faster-Growing Industries

It is assumed that during the 1982-87 period gross private domestic investment will be stimulated by somewhat lower interest rates and by a continuation of polices geared toward increasing investment outlays. Not surprisingly then, several of the industries within the faster-growth group are related to the building industry, both residential and non-residential structures. Lumber, for example, is expected to be the fastest growing industry over the forecast period, at an annual trend growth rate of 6.7 percent. Likewise, most of the remaining industrial groups in the faster-growth category fall within the broad-termed investment description of producers' durable equipment. Finally, the emphasis presently given to upgrading the U.S. defense posture has been translated into an expectation for strong growth in shipments of military-related hardware, including ships and airplanes, and also for ammunition and other ordnance.

The Moderate-Growth Industries

The ten key industries sharing the moderate-growth grouping also tend to reflect the expectation of greater investment spending occurring over the next several years. Spending for both plant and equipment and for residential structures will ultimately affect such diverse industries as rubber and plastics; chemicals; primary metals including steel, copper, lead, and aluminum. Moreover, the broad expansion of the economy will promote an intensification of investment in transportation facilities and vehicles — both freight and public transportation enterprises will be affected. Also considered among the more moderate growth industries in terms of product shipments over the next several years will be several non-manufacturing industries that are typically substantial employers of people.

First on the growth list for labor intensive industries is trade (both wholesale and retail). The trend growth rate of personal comsumption expenditures through 1987 is expected to exceed 9 percent and will help fuel the resumption of more normal expansion in wholesale and retail product shipments. The financial services industry, which is an agglomeration of such loosely related enterprises as: finance, insurance, real estate, and business and personal services, will achieve overall growth rates in product shipments that are nearly as great as for trade. Importantly, within the services category the expansion of business services and of personal and repair services will exceed the average rate of growth of the moderate group.

The Slower-Growth Industries

Among the slower-growth industries, the paper industry most clearly reflects the anticipated expansion of the overall economy. Many of the industries comprising the paper group are typically thought of as indicators of general economic conditions; especially, paper and paperboard mills, and paperboard container shipments. The projected 3.5-4 percent annual trend growth rate of the "packaging materials" product shipments reflects a rather unspectacular economic environment for much of the next several years.

The industry categories of mining and petroleum seem to be somewhat out-of-place within the slower-growth industry grouping. However, these two categories, upon closer inspection, include natural gas and crude petroleum extraction as well as petroleum refining, fuel oil, and paving and asphalt. Excluding those two categories, which are presently experiencing a period of weakened prices due to production excesses given current consumption, the remaining enterprises are expected to see product shipment gains that approach those for the moderate growth industries. Of particular importance, stone and clay mining and chemical fertilizer mining are both forecast to experience substantial relative growth in product shipments over the next several years.

COMPARATIVE INDUSTRY GROWTH

(Product Shipments In Producer Prices)
1982-1987

	Annual Trend Growth Rates
FASTER GROWTH	
Lumber	6.7%
Instruments	6.6
Non-Electrical Machinery	6.4
Transportation Equipment	6.2
Electrical Machinery	6.1
Communications	5.9
Furniture	5.8
Ordnance	5.6
Metal Products	5.3
Stone, Clay, Glass	5.2
MODERATE GROWTH	
Rubber and Plastics	4.9
Construction	4.9
Chemicals	4.7
Transportation	4.6
Miscellaneous Manufacturing	4.1
Metals	4.1
Trade	4.0
Financial Services	3.9
Government Enterprises	3.8
Textiles	3.6
SLOWER GROWTH	
Paper	3.5
Printing and Publishing	2.9
Apparel	2.8
Mining	2.4
Petroleum	2.3
Utilities	2.2
Agriculture	2.0
Food Processing	1.6
Leather Products	1.3
Tobacco Products	0.9

PAST AND FUTURE COMPARATIVE GROWTH TRENDS

In the previous section some 200 separate industries, as defined in accordance with the Standard Industrial Classification Code, were aggregated into 30 major economic categories and then ranked in terms of their relative growth rates from 1982 through 1987. The unit of measurement was "product shipments in producer prices." In this section, rather than assess the industries according to "current dollar" shipments, the effect of inflation has been removed to provide a consistent framework for analyzing major industry segments. Thus, roughly similar or related investment categories can be evaluated in terms of inflation-adjusted or "real" product shipment levels. Ten primary categories have been chosen: consumer discretionary — durables; consumer discretionary — nondurables and services; consumer nondiscretionary — durables; utilities; capital spending; technology; financial; energy; industrial commodity; and, retail.

As a point of reference, it is interesting as well as informative to compare the ten major-industry segments in terms of real growth in output as anticipated for the period 1981-1987 with the actual growth in output for the period 1973-1981. The second step is to analyze the sub-groupings within the major industry segments in order to determine why changes, if any, occur between historical and expected industry segments' growth rates.

Industry Growth and Real GNP — Technology

Four industry segments are expected to record real growth rates over the 1981-87 period that will exceed the trend growth rate of GNP (3.2 percent). The most rapidly growing of the foursome will be the "technology" segment, with a forecast trend growth rate of 6.7 percent. Likewise, during the 1973-81 timespan, the technology segment outperformed all other industry segments. Clearly the age of technology will provide continued thrust in the coming years, but while real growth in the office equipment category was more than double that for electronics during the 1973-81 period, the years immediately ahead will see a shift in emphasis, with electronics actually outpacing the growth rate for office equipment.

One of the main reasons for the reversal in roles is the slower growth of computers and related equipment. That market will expand just under 7 percent annually for the forecast period compared with roughly twice that pace for the historical period. Moreover, electronic technology applications are expected to accelerate in other industry categories; for example, in the communications equipment field, in sales of electronic components, in engineering and scientific applications, and in medical and surgical uses. As will be seen later, although there has been a reversal in roles among the industry sub-groupings of the technology segment, the overall segment outlook is very bright given the anticipated surge in capital spending that is forecast to occur during the 1981-87 period.

COMPARATIVE GROWTH TRENDS
(Compound Annual Growth Rates by Sector and Primary Industry)

	Real Growth (%)	
	73-81	81-87
Consumer Discretionary — Durables	**1.1**	**3.3**
Automobile	0.3	3.9
Automobile Parts	0.9	4.5
Building Materials	0.4	4.4
Household Appliances	3.3	2.8
Textile and Apparel	2.4	1.9
Tire and Rubber Goods	0.5	3.0
Consumer Discretionary — Nondurables and Services	**3.2**	**3.1**
Brewers and Distillers	3.9	1.9
Cosmetics and Toiletries	3.7	4.2
Photography	6.2	5.9
Publishing	2.4	2.2
Soft Drinks	1.6	2.1
Air Transportation	3.9	4.2
Hotel-Motel and Restaurants	3.3	4.6
Leisure Time	2.9	2.2
Consumer Non-Discretionary — Nondurables	**1.9**	**1.7**
Containers — Metal and Glass	1.3	2.0
Drug and Medical Supplies	4.5	4.8
Food and Allied Products	1.7	1.1
Soaps	3.7	4.2
Tobacco and Allied Products	0.3	0.7
Utilities	**2.0**	**3.2**
Telecommunications	6.4	5.8
Utilities — electric	1.4	3.0
Utilities — natural gas	–1.9	–1.3
Capital Spending	**2.7**	**5.3**
Aerospace	7.5	9.6
Electric Equipment	1.7	4.6
Machinery, General	1.5	3.2
Transportation	0.0	1.9
Technology	**6.2**	**6.7**
Electronics	5.0	6.8
Office Equipment	10.2	6.3
Financial	**3.3**	**2.7**
Banks and Finance Companies	3.9	3.0
Insurance	2.8	2.4
Energy	**3.0**	**1.4**
Machinery — oil well	3.2	2.6
Oil — domestic and international	3.0	1.2
Industrial Commodity	**1.1**	**3.1**
Chemical and Allied Products	3.0	3.5
Forest Products	0.8	4.9
Metals and Mining	–0.2	2.5
Paper and Paper Containers	1.9	2.6
Retail	**2.1**	**2.9**

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Capital Spending

The recent changes in corporate income tax structure and the emphasis on stimulating capital spending are expected to promote a strong surge in the "capital spending" segment, pushing that segment's growth rate to the number two spot for the 1981-87 projection. By comparison, the 1973-81 ranking for that segment was number five. The expected trend rate of real growth in the capital spending segment over the projection period, at 5.3 percent, is almost double that of the previous period. Beyond a general improvement in capital spending, the goal of achieving a substantially strengthened military posture over the next several years will require outlays of major proportions for both primary military suppliers and for their secondary, peripheral suppliers. Of course, within the major industry segment some sub-groups will outperform others.

In the aerospace sub-group, capital spending on aircraft should record the highest growth rates. The higher growth will be a result of increased defense spending and — expected later in the period — a turn around in the commercial airline industry. Transformers and switches, followed by engines and turbines are foreseen as the leading capital spending components in the electric equipment sub-group. In the general machinery sub-group the best performer is metal machine tools. (Metal machine tools actually posted a decline of more than three percent during the 1973-81 span.) Also within the capital spending segment, the railroad-industry category of the transportation sub-group is expected to show some revival after averaging almost no growth for the historical period.

Consumer Discretionary — Durables

Real growth trends in the "consumer discretionary — durables" segment are projected to average above the real growth level forecast for GNP, but only barely, at 3.3 percent. Nonetheless, that growth rate is third highest among all ten segments. Even more importantly, during the previous period that segment registered a far more modest 1.1 percent growth rate. A quick look at the industry sub-groups comprising the consumer discretionary — durables aggregate helps explain the turnaround. For example, in recent years the industry subgroups of automobiles, automobile parts, tire and rubber goods, and building materials have performed quite poorly. As a result, as these industries begin to revive, they will be coming off of very dismal prior-period results; modest improvement appears to be significant.

While it is presently anticipated that the auto and building industries will recover, on average, during the projection period, it is also of great significance that the concurrent interest rate environment will preclude any phenomenal rebound. Indeed, a worse interest rate climate could reduce considerably the strength of any rebound. By definition, the discretionary nature of this market segment causes its forecasted real growth rate to be subject to a number of external influences — particularly those related to consumer attitudes and buying plans. In addition, some sub-groups of this market segment, particularly household appliances and the textile and apparel industries, are expected to show slower real growth for the 1981-87 period than for the 1973-81 period.

Utilities

Real growth in utilities over the 1981-87 forecast period is expected to average right at 3.2 percent, or exactly the same as the trend growth rate of GNP. That rate of increase for utilities would accord it the fourth place ranking in terms of real growth rates among all ten industry segments. Notably, the utilities sector was only in seventh place in the growth-ranked array of the historical 1973-81 period. Just as interesting, the telecommunications (telephone and telegraph) sub-group is assumed to show lesser growth over the projection period than for the historical period. The telephone

and telegraph industries have seen their market positions eroded by new information transmitting technologies and also by increased competition from nonelectronic delivery systems. In addition, slower economic growth, particularly the homebuilding slowdown, has had a negative influence on telecommunications orders.

Both electric utilities and natural gas utilities have been through some uncomfortable times during the past several years. To mention just a few of the abrasive market forces that those industries have had to indure: soaring financing and capital costs; cost pressure increases from all phases of production — generating costs have been pressed ever higher from both market and environmental forces — the revenue side have been blasted by mounting rate resistance. Nonetheless, the outlook for the next several years for both electric and natural gas utilities is somewhat improved compared with the immediate past. In particular the capital cost trend should be improving and at the same time a modest revitalization in business capital spending should improve industry product shipments.

Consumer Discretionary — Nondurables and Services

The fifth place ranking for real growth among the ten principal market segments actually shows a tie for the forecast period. However, the "consumer discretionary — nondurables and services" segment will be discussed first since it also showed a high ranking during the historical period. The "industrial commodity" segment — also tied for fifth place in the projected real-growth array — will be discussed in the next section. With a projected real-growth rate of 3.1 percent for the 1981-87 period, the "consumer discretionary — nondurables and services" segment is expected to fall slightly below the anticipated 3.2 percent rate of expansion for the economy as a whole. In contrast, this segment outperformed the overall economy during the historical period.

Probably the most striking observation concerning this market segment's real growth prospects is that there is actually very little projected change in the real magnitude of consumer spending on nondurables and services. The discretionary nature (by definition) of this market segment in terms of its place in the consumer budget might lead one to expect a greater cyclical response than is apparent. However, it is likely that much of the cyclicality of the interim years has been lost by using the average growth rate. Be that as it may, since the effects of 1973-75 recession and the lesser 1980 recession are not readily apparent, it would seem that consumer discretionary spending on nondurables and services is a rapidly responding category, increasing or decreasing quickly as indicated by consumer attitudes.

Industrial Commodity

As in the previous section, the "industrial commodity" segment is projected to show a real growth rate of 3.1 percent, just under the real growth rate forecasted for the nation for the 1981-87 time span. During the historical period the industrial commodity segment was ranked ninth in terms of real growth when compared with the other nine primary-market segments. Moreover, the historical growth rate of 1.1 percent is well below the rate for the economy as a whole. Unlike the consumer-discretionary segment just discussed, the industrial commodity segment has displayed a high degree of response to business cycles swings.

The sub-group of metals and mining experienced pervasive weakness among its industries during the historical period but is expected to record a moderate growth rate for the forecast period. The forest products subgroup will follow similar trends, but the rebound in the overall economy and in construction in particular will allow the forest products industries to achieve an aggregated growth rate of almost 5 percent. Within the industrial commodity segment, the two subgroups of chemical and applied products, and paper and paper containers showed moderate expansion for the historical period and are projected to continue to show a moderate and sustainable growth trend for the forecast period.

Other Major Market Segments

The four remaining market segments all have projected real growth rates that are well below the trend growth rate for the economy and are therefore considered as a group. Both the "retail" and the "nondiscretionary — nondurables" segments, with respective growth rankings of number six and number eight, reflect the anticipated moderate recovery in the consumer sector. It is assumed that neither of these segments will be propelled by a prolonged surge in consumer spending nor by a significant change in consumer buying patterns in the years immediately ahead. Moreover, during the historical period both segments were ranked according, to their real growth rates, at the same level as during the forecast period, sixth and eighth.

The "financial" and "energy" segments are similar in that both registered substantial declines in their position in the real-growth-rate array. Financial slipped from second place during the 1973-81 period to an expected ranking of seventh place for the 1981-87 period. The prolonged period of relatively high interest rates and moderate economic growth has clearly already begun to take a toll on the growth on banks, finance companies, and insurance companies. As for the energy segment, the crude petroleum and petroleum refining industrial classifications will both see substantial reductions in their growth rates as a result of current production excesses worldwide. Industry observers typically feel that the "oil glut" could last for the next several years unless major production cutbacks occur or unless there is some major confrontation or cataclysmic event to disrupt anticipated production levels.